APPENDIX

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Petition for Certiorari filed December 27, 1977.
Certiorari Granted March 6, 1978.

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STATUTORY NOTICE OF DEFICIENCY

[Excerpts]

[June 20, 1969]

* * *

(b) The deduction of $136,150.36 for bad debts under reserve method is disallowed to the extent of $74,790.80 because it has not been established that any amount in excess of $61,359.56 constitutes a reasonable addition to the reserve under section 166 of the Internal Revenue Code of 1954.

* * *

Exhibit A

Computation of Net Operating Loss

TAXABLE YEAR ENDED DECEMBER 31, 1962

Adjustments to Income

Taxable loss disclosed by return		($5,185,160.83)
Additional income and unallowable deductions:		
(a) Inventory reserve	$1,079,069.00	
(b) Dividend	128,837.00	1,207,906.00
Taxable loss adjusted		($3,977,254.83)

Explanation of Adjustments

(a) The deduction of $22,279,949.71 claimed for cost of goods sold is disallowed to the extent of $1,079,069.00 representing writedown of inventory due to anticipated losses because it has not been established that such amount constitutes an allowable deduction under section 162 or any other section of the Internal Revenue Code of 1954.

* * *

TAX COURT OF THE UNITED STATES

THOR POWER TOOL COMPANY, *Petitioner*, vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent*.	Docket No. 4795-69

PETITION

[Filed 9-18-69]

The above-named Petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (bearing symbols A:R:SN) dated June 20, 1969, and, as the basis for its case, alleges as follows:

1. Petitioner is a Delaware corporation and has, and at all times relevant hereto has had, its principal place of business and its principal office at 175 North State Street, Aurora, Illinois 60507. The returns for the periods involved herein were filed with the office of the District Director of Internal Revenue at Chicago, Illinois.

2. The notice of deficiency and the statement referred to therein (copies of which are attached hereto and collectively marked Exhibit A) were mailed to Petitioner on June 20, 1969.

3. The Commissioner determined a deficiency in income tax for the calendar year 1963 in the amount of $545,977.64, of which approximately $491,951.00 is in controversy, and for the calendar year 1965 in the amount of $59,701.35, of which approximately $58,927.00 is in controversy.

4. The determination of tax set forth in said notice of deficiency is based upon the following errors:

(a) The Commissioner erred in determining the taxable income of Petitioner for the calendar year 1963 by "grossing up" as dividend income to Petitioner, under I. R. C. § 78, $161,927.00 of foreign taxes which the Commissioner alleges were deemed paid under I. R. C. § 902 by Petitioner as a result of dividends received in 1963 from Thor Power Tool Company, Limited ("Limited"), its wholly-owned English subsidiary.

(b) The Commissioner, in determining the taxable income of Petitioner for the calendar year 1963, erred in computing the net operating loss deduction available under I. R. C. § 172 as a carryback from a net operating loss incurred by Petitioner in 1964 by treating as 1964 dividend income to Petitioner, under I. R. C. § 78, $128,837.00 of foreign taxes which the Commissioner alleges were deemed paid by Petitioner under I. R. C. § 902 as a result of dividends received in 1964 from Limited. The Commissioner should have treated as 1964 dividend income to Petitioner no more than $83,344.00, which is the amount of tax deemed paid by Petitioner on its subsidiaries' accumulated profits attributable to 1963.

(c) The Commissioner, in determining the taxable income of Petitioner for the calendar year 1963, erred in computing the net operating loss deduction available under I. R. C. § 172 as a carryback from a net operating loss incurred by Petitioner in 1964 by disallowing for that year $1,079,069.00 of the $22,279,949.71 claimed by Petitioner as its cost of goods sold for that year. The Commissioner's adjustment included in closing inventory on December 31, 1964, $1,079,069.00 of unsalable goods which were

obsolete or excess, and which Petitioner had excluded from such inventory. The Commissioner also erred in requiring that Petitioner's claim for cost of goods sold in 1964 must be established as an "allowable deduction" under I. R. C. § 162 or other deduction section of the Code.

(d) The Commissioner erred in determining the taxable income of Petitioner for the calendar year 1965 by disallowing as a deduction, under I. R. C. § 166, $74,790.80 of the total $136,150.36 Petitioner had added to its reserve for bad debts.*

(e) The Commissioner erred in calculating (in Exhibits E and F of the notice of deficiency) the credits for foreign income taxes available to Petitioner in 1963 and 1965. This error is based in part on his failure to recognize that Petitioner claimed the global election in each of the years covered by Exhibits D and E, and in part on his failure to include Petitioner's 1963 taxable income from Canada in determining the overall foreign tax credit limitation for that year under I. R. C. § 904. Insufficient information has been supplied by the Commissioner to determine what other errors, if any, may have been made in his foreign tax credit calculation.

5. The facts upon which Petitioner, who at all times relevant hereto prepared and filed its income tax return on a calendar year basis and used the accrual method of accounting, rely as the bases of this case are as follows:

(a) All of the dividends paid by Limited to Petitioner in 1963 were paid from profits accumulated in 1962 or earlier years by Limited or by Limited's wholly-owned subsidiaries, Thor Tools, Ltd. ("Tools") and Thor Power Tool, GmbH ("GmbH"). Under I. R. C. § 78 foreign taxes deemed paid by Petitioner with respect to such dividends are not required to be included in Petitioner's income for 1963.

* Petitioner does not contest the Commissioner's disallowance of a claimed deduction of $1,627.00 for organization expenses, and Petitioner agrees to pay the tax resulting therefrom together with any interest due thereon.

(b) None of the dividends paid by Limited to Petitioner in 1964 were paid from profits accumulated in 1964 by Limited, Tools or GmbH. Of these 1964 dividends, at least $130,893.00 were paid from profits accumulated in 1962 or earlier years by Limited or by its subsidiaries, Tools and GmbH. Under I. R. C. § 78, foreign taxes deemed paid by Petitioner with respect to that portion of 1964 dividends paid out of profits accumulated in 1962 or earlier years are not required to be included in Petitioner's income for 1964.

(c) Petitioner at all times relevant hereto valued its inventory on the basis of the lower of cost or market. As part of closing its books and preparing its annual financial reports and its income tax return for calendar year 1964, Petitioner's management ordered a detailed analysis of its existing inventory to assure that it would accurately reflect its value on the basis of sound accounting principles. This analysis revealed that quantities of certain items in the inventory were unsalable because they were obsolete or in excess of the foreseeable market demand for such items, and it was further determined that their direct cost of disposal was equal to or exceeded their potential disposal price. This reduction in closing inventory included the following:

(i) Based on their then knowledge of the power tool industry in general and Petitioner's product lines in particular, including the rate of

technological innovation, resulting obsolescence and Petitioner's most recent sales and usage, Petitioner's management determined the following portions of such inventory items to be unsalable as obsolete or excess:

Number of Months' Supply—Based on 1964 Sales/Usage	**Incremental Percent of Inventory Determined to Be Unsalable**
1-12	0%
13-18	50% over 12 mos.
19-24	75% over 18 "
over 24	100% over 24 "

This adjustment amounted to $918,862.00

(ii) An additional adjustment of $160,210.00 was made in the value of certain categories of inventory where management believed that the adjustment described in subparagraph 5(c)(i) was not accurate or not applicable.

The determination of the quantities of inventory items which were unsalable as obsolete or excess was made after a careful analysis by Petitioner's management, was based on extensive experience, and is consistent with I. R. C. § 471 which requires that inventories be valued on a basis "conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income" of the taxpayer, and in particular with *Treas. Reg.* § 1.471-2(c) which provides in relevant part:

"Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, . . . should be valued at bona fide selling prices less direct cost of disposition, whether subparagraph (1) [cost] or (2) [lower of cost or market] of this paragraph is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value."

(d) Petitioner at all times relevant hereto has accounted for bad debts on the reserve method. In late 1965, an analysis of Petitioner's accounts receivable was undertaken in order to determine the amount of reserve reasonably required to offset expected losses on such accounts. All inter-company accounts with related companies were deemed to be fully collectible, and no reserve was taken against them. All unrelated customer accounts of over $100 which were more than 90 days past due were considered individually, on the basis of currently available credit information and experience with each debtor. A portion of these accounts were specifically deemed to be wholly uncollectible, and a 100% reserve was taken against them. A similar ratio was applied to customer accounts with balances of less than $100 which were more than 90 days past due. Finally, the remaining accounts were aged and a reserve of 1% was taken against those accounts which were current and a reserve of 2% against those which were then past due. This analysis revealed that not less than $228,947.00 of Petitioner's accounts receivable would be uncollectible, requiring an addition to the reserve for bad debts in the amount of $136,150.36. The Commissioner, however, has disallowed $74,790.80 of this addition to the reserve for bad debts, apparently on the basis that the historical bad debt experience of Petitioner was the sole factor to be relied upon in determining the reasonableness of Petitioner's reserve, ignoring the detailed analysis conducted by Petitioner.

(e) Petitioner at all times relevant hereto has calculated its foreign tax credit limitation on the basis of the overall limitation, provided for in I. R. C. § 904(a)(2). Petitioner's taxable income from Canadian sources in 1963 was $113,343.00 (rather than $136,945.00, as previously reported by Petitioner). The Commissioner failed or refused to take these facts into account in calculating Petitioner's foreign tax credit limitation for 1963 and 1965. Because the Commissioner's notice of deficiency contains insufficient information, it is impossible to determine whether or not additional relevant facts have been ignored.

WHEREFORE, Petitioner prays that this Court may hear this case, determine that the Commissioner erred as alleged in the assignments or error as set forth in paragraph 4 above, determine that there is no deficiency in income tax for the calendar years 1963 and 1965 (except such income tax as may be due as a result of the agreed upon disallowance in 1965 of a deduction for organization expenses in the amount of $1,627.00, the inclusion in Petitioner's 1964 income under I. R. C. § 78 of $83,344.00, and the decrease in Petitioner's 1963 taxable income from Canadian sources by $23,602.00) and grant such other and further relief as this Court may determine to be just and appropriate.

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[Caption Omitted]

ANSWER

[Filed Nov. 18, 1969]

The Respondent, in answer to the petition filed in the above-entitled case, admits and denies as follows:

1. Admits that petitioner is a corporation with its principal office and place of business at 175 North State Street, Aurora, Illinois 60507, and that the returns for the periods involved herein were filed with the office of the District Director of Internal Revenue at Chicago, Illinois. Denies the remaining allegations of paragraph 1. of the petition.

2. Admits the allegations of paragraph 2. of the petition.

3. Admits that the Commissioner determined a deficiency in income tax for the calendar year 1963 in the amount of $545,977.64, and for the calendar year 1965 in the amount of $59,701.35. Denies the remaining allegations of paragraph 3. of the petition.

4.(a) through (e) Denies that the Commissioner erred as alleged in subparagraphs (a) through (e) of paragraph 4. of the petition.

5.(a) through (c)(ii) Denies the allegations of subparagraphs (a) through (c)(ii) of paragraph 5. of the petition.

(d) Admits that petitioner at all times relevant hereto has accounted for bad debts on the reserve method. Denies the remaining allegations of subparagraph (d) of paragraph 5. of the petition.

(e) Denies the allegations of subparagraph (e) of paragraph 5. of the petition.

6. Denies generally each and every allegation of the petition not hereinbefore specifically admitted, qualified, or denied.

Wherefore, it is prayed that the deficiencies determined by the respondent be in all respects approved.

/s/ K. Martin Worthy (GTD)
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[Caption Omitted]

MOTION FOR ORDER (i) ESTABLISHING BURDEN OF PROOF ON NEW ISSUE AND (ii) TO KEEP RECORD OPEN AFTER TRIAL FOR PROOF OF YEAR IN WHICH INVENTORY BECAME EXCESS

[Filed May 25, 1972]

The Petitioner Moves, pursuant to the provisions of Rules 19 and 32 of the Rules of Practice of the United States Tax Court, that the Court issue an order: (i) that the burden of proof shall be on the Respondent if Respondent puts in issue whether the Petitioner changed its method of accounting without permission, as required by I. R. C. § 446(e), for the year 1964; and (ii) that the record in this case shall remain open after the trial and for a reasonable period after the decision herein for the purpose of receiving evidence concerning the year or years in which items of inventory became excess and unsaleable, if by virtue of the Court's decision such evidence is relevant to a determination of Petitioner's tax liability.

In Support of Its Motions, Petitioner states the following:

1(a) The Statutory Notice of Deficiency ("SND") issued by Respondent on June 20, 1969, which is designed to inform Petitioner concerning the amount of tax at issue and the reasons why Respondent contends that that amount is at issue, contained the following explanation concerning the 1964 closing inventory issue in this proceeding:

> "The deduction of $22,279,949.71 claimed for cost of goods sold is disallowed to the extent of $1,079,069.00 representing writedown of inventory due to anticipated losses because it has not been established that such amount constitutes an allowable deduction under section 162 or any other section of the Internal Revenue Code of 1954."

(b) In the Petition filed herein, Petitioner alleged that Respondent erred in computing Petitioner's net operating loss deduction for 1964

> ". . . by disallowing for that year $1,079,069.00 of the $22,279,949.71 claimed by Petitioner as its cost of goods sold for that year. The Commissioner's adjustment included in closing inventory on December 31, 1964, $1,079,069.00 of unsaleable goods which were obsolete or excess, and which Petitioner had excluded from such inventory. The Commissioner also erred in requiring that Petitioner's claim for cost of goods sold in 1964 must be established as an 'allowable deduction' under I. R. C. § 162 or other deduction section of the Code."

(c) The Answer filed by Respondent herein denies the relevant allegations of the Petition, but does not raise or advert to any legal theories other than those contained in the SND.

(d) Petitioner is prepared to establish at trial that the $1,079,069.00 at issue herein was properly included in its computation of cost of goods sold for 1964 and that there is no legal requirement that Petitioner establish this or any portion of its cost of goods sold as a deduction under I. R. C. § 162 or any other section of the Code, for the reason that cost of goods sold is a constitutionally required deduction from gross receipts in calculating gross income as defined in I. R. C. § 61.

(e) At a recent conference, counsel for Respondent indicated that Respondent may assert at trial that Petitioner is precluded from including the amount in issue in its computation of cost of goods sold for 1964 on the ground that Petitioner allegedly changed its method of accounting that year without the consent of the Respondent in violation of I. R. C. § 446(e). While that theory had been mentioned, without citation of any section of the Code, in the Revenue Agent's Report (Form 1907) issued October

16, 1967, it was not contained in the SND (issued June 20, 1969), and therefore it was only recently that Petitioner learned that Respondent might rely on that theory at trial.

(f) Petitioner contends that if I. R. C. § 446(e) is put in issue by Respondent in this proceeding, it will constitute the introduction of a "new issue" within the meaning of Rule 32 of the Rules of Practice of the United States Tax Court and, therefore, that the burden of proof on such new issue should be upon Respondent pursuant to the requirements of Rule 32.

(g) Petitioner believes that a ruling by the Court, at the earliest possible date, on who will bear the burden of proof if Respondent chooses to put I. R. C. § 446(e) in issue is necessary in order to permit a fair and complete preparation for and presentation of Petitioner's case at the trial. If Petitioner should be deemed to have the burden of proof to establish that it did not change its method of accounting, its preparation for trial and presentation of its case will be substantially different, requiring additional evidence.

2. (a) Counsel for Respondent has also indicated that if Petitioner prevails on the merits of this case, Respondent will rely on the theory that part or all of the amount in controversy should have been included in Petitioner's cost of goods sold in years before 1964, precluding its inclusion in 1964.

(b) Petitioner contends that the excess inventory items at issue herein were properly includible in cost of goods sold when they were identified as excess by management in 1964. As a result, Petitioner believes that introduction of voluminous proof concerning the year of production, the year of purchase, patterns of consumption, etc. will not be necessary in the trial of this case.

(c) Petitioner further believes that the mitigation provisions of I. R. C. § 1311 *et seq.* (and especially I. R. C. § 1312(1) relating to double inclusion of an item in gross income) are applicable, and will permit Petitioner essentially the same tax benefit regardless of whether the items at issue herein should have been excluded from Petitioner's gross income as part of its cost of goods sold in 1964 or in some prior year. This also would eliminate the need for the evidence referred to herein.

(d) In the event the issues described in Paragraphs 2(b) and 2(c) of this motion are decided against Petitioner, it further believes that Petitioner and Respondent will be able to review the books and records of Petitioner as part of a Rule 50 calculation and reach agreement concerning which year items should have been included in cost of goods sold. This too would eliminate the need for introduction of such evidence.

(e) Because it would not be necessary if the Court finds in favor of Petitioner in accordance with Paragraphs 2(b) or 2(c) hereof; if a stipulation is agreed to as contemplated in Paragraph 2(d); or if the Court's decision is adverse to Petitioner, and in the interest of saving the time of the Court, Respondent and his counsel and Petitioner and its counsel, Petitioner requests that the trial in this matter be limited to the other issues, excluding any factual inquiry into the year specific items of inventory became excess. Petitioner further requests that the record in this proceeding remain open pending the Court's decision so that if Petitioner prevails but is called upon to establish the year the goods became excess, and if resolution is not possible under the procedures described in Paragraphs 2(c) and 2(d) hereof, then in such event Petitioner may introduce relevant evidence to establish the year in which said inventory became excess.

Because of the importance of both of the issues raised in this motion, and because of their effect on both Petitioner and Respondent in preparing and presenting their

case herein, Respondent requests that the Court expedite consideration of this motion and the issuance of its ruling hereon.

WHEREFORE, it is prayed:

1. That both motions be granted:

(i) that the Court rule that Respondent has the burden of proof if it puts I. R. C. § 446(e) in issue herein; and

(ii) that the record in this case shall remain open after the trial and for a reasonable period after the decision herein for the purpose of receiving evidence concerning the year or years in which items of inventory became excess and unsaleable if by virtue of the decision herein such evidence is relevant to a determination of Petitioner's tax liability; and

2. If Respondent does not agree to the issuance of the rulings requested herein, that a hearing on both motions be heard at a convenient date on or prior to June 7, 1972, at which time Petitioner will present a memorandum of law in support of these motions.

/s/ MARK H. BERENS
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[CAPTION OMITTED]

ORDER

Pursuant to Order of the Court on May 30, 1972, petitioner's Motion for Order (i) Establishing Burden of Proof on New Issue and (ii) to Keep Record Open After Trial for Proof of Year in Which Inventory Became Excess, filed on May 25, 1972, was called for hearing at the Motions Session of the Court beginning at 10:00 A.M. on June 14, 1972. Counsel for petitioner and counsel for respondent appeared to argue their respective positions. After full consideration and for reasons appearing in the record in this case, it is

ORDERED that petitioner's motion filed on May 25, 1972, is hereby granted and the burden of proof shall be on respondent under the conditions set forth in petitioner's motion and the record shall be kept open after trial under the circumstances set forth in petitioner's motion.

/s/ WILLIAM A. GOFFE
Judge

Dated: Washington, D. C.
June 14, 1972

[CAPTION OMITTED]

AMENDMENT TO ANSWER

[Filed June 22, 1972]

The Respondent, pursuant to the views expressed by the Court in response to petitioner's motion filed with the Court on May 25, 1972, with respect to the burden of proof as to whether a change of accounting method occurred in 1964 within the meaning of section 446(e) of the Internal Revenue Code of 1954, and as to whether such issue was properly before the Court, but reserving all of his rights in this matter and without conceding the correctness of any such views, adds after paragraph 6. and prior to the prayer the following allegations:

7. In Further Support of the determination in the statutory notice herein set forth as adjustment (a) to income for the taxable year ended December 31, 1964, the respondent alleges:

(a) In computing its inventory as of December 31, 1964, petitioner applied the procedures described in subpargaraph 5.(c)(i) and (ii) of its petition herein.

(b) Such procedures were not applied to petitioner's inventory as of December 31, 1963.

(c) Petitioner did not secure the consent of the Secretary or his delegate to the use of said procedures.

(d) The adoption of said procedures constituted a change of accounting method within the meaning of section 446(e) of the Internal Revenue Code of 1954.

WHEREFORE, the respondent prays that the Court grant the prayer requested in his answer.

/s/ LEE H. HENKEL, JR. (GTD)
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[CAPTION OMITTED]

REPLY TO AMENDMENT TO ANSWER

[Filed June 22, 1972]

Petitioner, for reply to the allegations affirmatively set out by the Respondent in his Amendment to Answer, admits and denies as follows:

7.(a) Admits that in computing its inventory as of December 31, 1964, petitioner applied the procedures described in subparagraph 5.(c)(i) and (ii) of its petition herein.

7.(b) Petitioner has insufficient knowledge and information upon which to determine the truth or falsity of the matters alleged in paragraph 7(b) and, therefore, denies the allegation that such procedures were not applied to Petitioner's inventory as of December 31, 1963. Petitioner does state that Petitioner applied the lower of cost or market method of accounting in determining its closing inventory as of December 31, 1963 and December 31, 1964, as well as in all preceding and following years to date.

7.(c) Admits that Petitioner did not secure the consent of the Secretary or his delegate to the use of said procedures.

7.(d) To the extent that this allegation constitutes a conclusion of law, Petitioner neither affirms nor denies the allegation. To the extent that it constitutes a factual allegation, Petitioner denies it.

WHEREFORE, it is prayed that the affirmative relief requested by the Respondent in his answer be denied.

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[CAPTION OMITTED]

STIPULATION OF FACTS

[Filed June 22, 1972]

1. Petitioner is a corporation organized under the laws of the State of Delaware, with principal office and place of business at Aurora, Illinois. Its corporate income tax returns for the calendar years 1960 to 1965, inclusive, were filed with the District Director of Internal Revenue at Chicago, Illinois. True and correct copies of said returns are annexed hereto, made a part hereof, and marked as Joint Exhibits 1-A to 6-F, inclusive.

2. At all times pertinent prior to 1964, petitioner's inventory was valued at the lower of cost or market. Petitioner's 1964 return, in answer to a printed question with respect to the valuation of inventory, states that inventory for that year was also

valued at the lower of cost or market, and that there was no substantial change in the manner of determining quantities, cost or valuations between the opening and closing inventories.

* * *

6.(a) Beginning in 1960 an account was created on petitioner's books and designated "Reserve for Inventory Valuation" (hereinafter "RIV"), which was an inventory contra-account, for the purpose of amortizing over a ten-year period the inventory value of parts and accessories kept in stock for discontinued tools, *i.e.,* tools no longer currently produced. An entry in the amount of $116,244.52 was made in this account as of 12/31/60, representing a 100% write-off of such parts and accessories for tools which went out of production during or prior to 1950, and corresponding write-downs on the basis of a ten-year amortization of such parts and accessories for tools which went out of production between 1951 and 1959, the latter receiving a ten-percent write-down.

A further addition of $30,966.35 was made in 1961, bringing the balance as of 12/31/61 to $147,210.87. As of 12/31/63 the balance in the account was in the amount of $152,117.00.

(b) During the first three quarters of 1964 $22,090.00 was added to the RIV account, resulting in a balance of $174,207.00 in the account as of September 30, 1964.

(c) For each of the years 1960 to 1963, inclusive, the net addition during the respective taxable year to the RIV reserve was reflected as a deduction in the computation of the closing inventory figure shown in the return.

7. In 1964 there was a major change in petitioner's management. New management concluded that existing inventory quantities were excessive.

8. Incident to closing the books and preparing its financial statements as of December 31, 1964, petitioner's new management undertook an analysis of its closing inventory as follows:

(a) A physical inventory was taken at all factories and branches.

(b) The remaining items of inventory (after the write-off described in the last sentence of paragraph 3, *supra.*) were written down as hereinafter described. The total number of inventory items involved were:

Raw material items	4,297
Work-in-process (material and parts) items	1,781
Finished parts (service and production) and accessories	33,670
Finished tools	4,344
Total number of inventory items	44,092

Two procedures were utilized in writing down the inventory described in paragraph 8.(b).

9. The first procedure was as follows:

(a) For each item, where such information was available, requirements for 1965 and later years were projected on the basis of actual "usage" during 1964.[1] For finished tools, "usage" was based on 1964 sales; for finished parts and accessories, "usage" was based on 1964 sales (for service parts) and 1964 production (for parts incorporated in tools); for raw material and work-in-process, "usage" was based on 1964 production.

(b) Utilizing the data obtained from the foregoing procedure, an inventory aging schedule was prepared which

1. Petitioner contends that there were adjustments for then known conditions that were expected to increase or reduce future requirements for some items, and reserves the right to offer evidence thereon. Respondent does not stipulate to the correctness of this contention, other than to agree that petitioner may introduce evidence consistent with its reservation herein.

compared the December 31, 1964 inventory quantities and the extended gross usable inventory values, per paragraph 9.(a) hereof, with the estimated market demand.

(c) Gross usable inventory values were then reduced as follows:

(i) That portion of the supply of each item of inventory not in excess of the amount determined by management to represent twelve months' "usage" was not written down.

(ii) As to each inventory item, that portion in excess of twelve months' "usage" but not in excess of eighteen months' "usage" was written down 50%.

(iii) As to each inventory item, that portion in excess of eighteen months' "usage" but not in excess of twenty-four months' "usage" was written down by 75%, *i.e.*, to 25% of the prior book figure.

(iv) As to each inventory item, that portion in excess of twenty-four months' "usage" was written off completely.

10. In addition, a second procedure was applied to the closing inventory as of December 31, 1964 at petitioner's LaGrange Park and Cincinnati plants. This was done because, in the opinion of management, data as to prior "usage" at those locations was inadequate to forecast future requirements accurately. This latter write-down in the amount of $160,210.00 is the write-down referred to in paragraphs 5(c)(ii) of the petition herein.

A summary prepared by petitioner of the write-downs of inventories made pursuant to this second procedure at the LaGrange Park (referred to therein as "Speedway") and Cincinnati plants is annexed hereto, made a part hereof, and marked as Petitioner's Exhibit 13.

* * *

[Caption Omitted]

[Transcript of Proceedings—22 June 1972]

Appearances:

Messrs. Mayer, Brown & Platt, By: Messrs. Mark H. Berens, Lee N. Abrams and John E. Allen, 231 South LaSalle Street, Chicago, Illinois, on behalf of the Petitioner;

Mr. Seymour I. Sherman, IRS, Chicago, Illinois, on behalf of the Respondent.

[i]

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* * *

[3] Mr. Sherman: Very well. Respondent moves at this time for leave to file the Amendment to Answer and asks leave of the Court to file the Motion and the attached Amendment to Answer accordingly.

I would note that at the time we discussed this matter in chambers, and I immediately went out and dictated the Motion and the proposed Amendment to Answer, I did not have before me a copy of the Order of the Court which is pursuant to a motion by Petitioner which had been argued in Washington on the 14th. Accordingly, I was unable to characterize any of the matters in terms of such Order, and had to use the expression relating to the expression of views by the Court.

I have since received the order and I would [4] ask that the Court consider that any statements with respect to the Court having expressed its views be read in the same light as the Court having so ordered with respect to the matters that have been argued in the Motion heard in Washington on the 14th.

The Court: Very well. Does the Petitioner still object to the filing of the Amended Answer?

Mr. Berens: First of all, we do not object on the grounds of time limits of the Motion to Amend. We continue our position in that regard.

We think, rather than having this Motion and the Amendment viewed as meaning something other than what it says, that it ought to be redrafted and resubmitted referring to the order of this Court on the interlocutory motion that has been argued by the government and decided by this Court.

Further, and quite apart from that, cleaning the documents up, we object to the reservation by the Respondent to reargue the motion that was argued in Washington by Respondent that was delayed one week in the argument so that Respondent could be prepared.

Mr. Sherman: If the Court please, the statements which I made with respect to the matter of the Order not having been before me in no way affect the substantive allegations in the Amendment to Answer.

[5] Also, there is no statement either in the Motion or in the proposed Amended Answer with respect to rearguing a Motion.

The sole statement there is, "But reserving all of his rights in this matter and without conceding the correctness of any such views," and this is the position I will adhere to.

Mr. Sherman: I would point out that there was no Order requiring an Amendment to Answer to be filed. The Order, rather, ordered that the burden of proof with respect to the change of accounting method be on Respondent.

The Court: Well, that is correct. I did not order Respondent to amend its Answer. I pointed out at the hearing that I would give the Respondent the opportunity to amend prior to trial, which, of course, Respondent is now doing.

I did it because I felt this was something that the Respondent bore the burden of proof on, and it should be pleaded.

I think I will overrule the Petitioner's Motion because I think the record is clear that this is not based on the views of the Court subsequent to the Order of the Court dated June 14, 1972, but I do want the record to be clear as to what did transpire at this pre-trial conference because no reporter was [6] present.

I will point out to some extent my basis for ruling on this Motion as I did.

The Petitioner filed a Motion on May 25, 1972. The Order was issued on May the 30th and served on Respondent on June 1, setting a Motion for hearing on June 14th.

Petitioner filed a Memorandum of Law. Respondent did not file a Memorandum of Law.

This hearing was set prior to the Calendar Call in order that the burden of proof might be established prior to the trial. I find this the logical, expedient way to handle something like this, so that if the burden of proof is going to be shifted, it will grant both parties an ample opportunity to rely on that prior to trial and obviate the necessity of continuing this case for the second time.

At the hearing in Washington, Respondent relied on the case of Arthur Soren, S-o-r-e-n, a 1958 case, cited at 29 Tax Court

959. That case involved a statutory notice which merely stated that a distribution from a corporation was taxable to the Petitioner at ordinary income tax rates.

Petitioner contended that if the defendant's theory which he proposed in that case that this was [7] income from a collapsible corporation, that it was new matter, and the Respondent should plead this and prove it.

Judge Opper, in deciding the issue against the Petitioner, held that because the statutory notice was in general terms, that such general terms would include the theory advanced by the Respondent.

In so doing, he distinguished cases previously decided by the Court of W. H. Weaver, 25 TC 1067, and Thomas Wilson, 25 TC 1058. In fact, Judge Opper himself had decided the Weaver case. He pointed out that in Weaver and Wilson the statutory notice was specific and Respondent attempted to rely on the theory not covered by the specific sections of the Code referred to.

I would like to state that the basis of my ruling on the Motion in Washington was that the statutory notice in this case was specific in that in this adjustment it relied on Section 162 of the Code.

It also had a phrase, "or any other section of the Internal Revenue Code," which I don't think puts anyone on notice as to what the issue is.

Therefore, that was the basis of my ruling on the Motion.

[8] Now, I did it at that time because I think it was important to do prior to the trial, and I can assure the Petitioner that the Respondent is reserving his objection to my ruling and wants to argue it on brief after the trial of the case, that I can assure Petitioner that I will give it very little weight because, to me, this is a matter that must be established prior to the trial of the case. But, if Respondent somehow convinces me that I ruled wrong, I will not decide the case against Petitioner on the basis of Petitioner's failure on burden of proof, but will instead

ask for a further trial of the case to permit the Petitioner to put on further proof because I think the burden of proof ought to be established prior to the trial, and I am not going to jeopardize the Petitioner's case by later saying that the Petitioner bore the burden of proof. I just want the record clear as to the reason for my ruling and the reason for my ruling on the Motion this morning.

So, I am granting the Motion to file the Amendment to Answer. I understand Petitioner has a Reply and a Memorandum to file.

Mr. Berens: Well, the Memorandum, in effect, states the arguments I just made for the record, and [9] the Reply would assume that the Amended Answer would be accepted by the Court, and the Reply directs itself entirely to denying or admitting the allegations in the Amended Answer.

The Court: Very well. Does the Respondent have objections to filing the Reply?

Mr. Sherman: No, Your Honor, but I will reserve the right. I just glanced at it this morning, and I believe there is one portion which is subject to a Motion with respect to striking as frivolous, and I would reserve the right to file such a Motion.

The Court: Strike as what, frivolous?

Mr. Sherman: To strike one denial in the Petition as frivolous. The Petition denies knowledge or information as to how the Petitioner computed its closing inventory balance as of December 31, 1963. It denies knowledge as to whether or not it applied to that closing balance the procedures which have been stipulated and are in issue in this case.

The Court: I take it you are referring to the Reply.

Mr. Sherman: That's correct, Your Honor.

The Court: I think you stated "Petition." You may reserve that objection.

Mr. Berens: Your Honor, that reservation [10] puts us in the same type of problem that we had that motivated our Motion in Washington to establish where the burden of proof is.

The allegation in the Amended Answer was that the procedures followed by the Petitioner at the end of 1964 in valuing excess inventory were not followed at the end of 1963.

Now, normally the Petitioner is a corporation, and normally it is aware of what it did from year to year, but we have a rather split personality situation here.

The corporation, at the end of 1964, was under entirely new management. To the extent that there were holdovers, they were not involved in this inventory evaluation.

We know what was posted to the books at the end of 1963, in valuing the inventory. We do not know, and we have not been able to find any working papers that indicate what procedures were used at the end of that year to post that amount. For all we know, procedures similar to those followed at the end of '64, that is, designed to reduce the inventory to what management thought was net realizable value, were followed at the end of '63, but that they concluded the amount was very small. I think the posting [11] at the end of '63 was something like $5,000.

Now, this is not a frivolous denial on our part. We received this Amended Answer the day before yesterday, in the late afternoon, and we drafted our reply yesterday noon, and at that time we were unable and the Petitioner was unable to determine what, in fact, had been done in 1963, in valuing the excess inventory.

Now, I want to make myself clear on this: We know this 10 per cent, 10-year evaluation procedure was followed in '63, that had been followed since 1960; that we know, but we don't know what else was done, if anything, and I think that at some point during the trial, and preferably at the outset, and while our principal company witness is on the stand, that we get a determination on this—I should put it differently—that Respondent make up its mind whether it is going to move to require us to amend this paragraph of the Reply or not, because if we are forced to amend it, we will have to present additional testimony.

If we are not forced to amend it, we will proceed as we had intended to proceed all along, and if Respondent, who has the burden of proof on this issue, wants to call company officials, present or [12] past, that's his prerogative at his time, when he presents his part of the case.

The Court: May I see the pleadings, please, the Amendment to the Answer and the Reply?

(Document tendered to the Court.)

The Court: Based upon the representations of Counsel for the Petitioner that the management of Petitioner changed—did I say based upon the representations of Counsel for the Petitioner?

Mr. Berens: Yes.

The Court:—that Petitioner's management was changed in the year 1964, I believe those representations were made in the hearing on the Motion before the Court in Washington, and the representations made this morning, which I assume the Petitioner will prove as part of its case, I find that the paragraph of the Reply, being Paragraph 7(b), the Reply to Amendment to Answer, is not frivolous, and, therefore, it will not be struck; that any allegations of the method applied to the inventory as of December 31, 1963 being part of the new matter raised in the Answer, the burden of proof rests on the Respondent to come forward with the proof.

Therefore, the objection is overruled and the Reply to Amendment to Answer is filed.

[13] Now, are there any other preliminary matters to take up?

Mr. Berens: None that I know of, Your Honor, other than the objections to some of the exhibits and the filing of a stipulation of issues which—is that here?

Mr. Sherman: No, that will be brought here and can be filed at any time this morning.

Mr. Berens: Oh. All of the issues besides the inventory issue and the bad debt issue have been stipulated by the parties, and that will be filed today.

The Court: Very well.

I believe in the proposed Stipulation of Facts, Respondent objects to Paragraph 13 of the proposed Stipulation.

Mr. Sherman: Yes, Respondent has objected to Exhibits 15, 16 and 17, Your Honor.

The Court: I think you object to Paragraphs 13 and 14 on the grounds of materiality and relevancy.

Mr. Sherman: Right.

Mr. Berens: Your Honor, we had understood it was an objection only to the exhibits, not to the material in the paragraphs.

Mr. Sherman: That is correct, Your Honor.

[14] The Court. You are correct. Respondent objects to Exhibits 15, 16 and 17.

Mr. Sherman: These matters all concern subjects substantially after the end of the taxable year, particularly in regard to Exhibit 17, which is a study of disposition of inventory from 1965 to 1971.

Exhibits 15 and 16 are the amounts claimed as excess inventory in the account as of the end of 1965 and 1966, and we are dealing with a question of an inventory procedure, and the inventory in the year 1964.

The Court: With respect to Exhibit 15, I find Exhibit 15 to be material and relevant because the taxable year 1965 is also before the Court.

Respondent made no adjustment to inventory for that year by reason of the method employed by Petitioner. I find Exhibits 15 and 16 both to be material and relevant because Regulation Section 1.471-2(b) provides that "The inventory method employed by the taxpayer shall be consistent."

I think it is material and relevant to show consistency following the taxable year involved.

With respect to Exhibit 17, Exhibit 17 attempts to—I suppose the Petitioner purports or alleges that it attempts to verify the correctness [15] of Petitioner's method of valuing inventory.

I feel this is relevant and material, and I will overrule Respondent's objection to that exhibit.

Therefore, I will overrule Respondent's objections to Exhibits 15, 16 and 17.

Now, I understand that the Petitioner objects to Exhibits—

Mr. Berens: M—

The Court: M and N.

Mr. Berens: Your Honor, yes, of Respondent.

The Court. Now, would you like to explain why you contend those are not admissible?

Mr. Berens: We have two objections to them, Your Honor. One being on the relevancy and the materiality of the mere pleadings in two civil adversary proceedings in which Thor happened to be a defendant.

The issue in those proceedings did, indeed, involve its accounting in 1964, not only in excess inventory, but in all kinds of other, both inventory and non-inventory areas. It involved contentions of fraud on the parts of some of the members of management, misleading financial statements, and so on.

The basis of that suit has some common basis with this one, insofar as the accounting of the [16] company is the underlying fact, but the allegations in the various pleadings do not establish their own truth.

As to the issues of this case, they are essentially hearsay, except insofar as pleadings by Thor could be treated as admissions against itself, and as to that aspect, we obviously have no objection.

The second basis of our objection which relates to, but is distinct from the first, and that is the competency, and in particular I focus on the pleadings of the parties to those suits other than Thor. They were attempting to either establish liability of Thor, or in some cases were attempting to deny their own liability.

In either event, the case was never tried and none of the pleadings are anything more than normal pleadings; that is,

allegations of unproved facts, and they are not only not material or relevant to this case, they are not competent.

The Court: Mr. Sherman?

Mr. Sherman: Your Honor, these pleadings involve two suits in which this Petitioner was the party in which not just an element but a very substantial element of the allegations with respect to improper prior accounting treatment dealt with them.

[17] Now, certainly Thor's own pleadings, the statements which it made with respect to the status of its inventory, are admissible against it in any subsequent proceedings as admissions. The other pleadings in this case are essential in order to know what it is Thor is pleading to, what is it denying in its pleadings, what is it alleging.

Thor was not merely a defendant in these cases, it was a defendant and a counterclaimant against its former accounting firm and possibly other parties, and I think that these pleadings are important and throw considerable light not only upon the question of the method of accounting, the propriety of the actions taken, but even on the question as to what had, in fact, been done with respect to December 31, 1963 inventory.

Here is the same Petitioner which, in its Reply, tries to hide under the table by saying, "We don't know what they did," but they know enough to allege in a pleading before the Federal District Court that they know pretty well what was done. I think this is highly pertinent.

The Court: Well, I think the subject matter of those lawsuits probably is material and relevant to the trial of this case, and I will overrule [18] Petitioner's objections. In so doing, I will point out that allegations of parties other than the Petitioner herein, Thor, will not be accepted as facts, but are merely allegations of fact not going to prove the matter of things herein to be true, except to the extent that Thor admitted such facts as being true.

Now, any allegations of Thor I will accept as being true. If they are against Thor, then I would say they would be admissions against an interest.

I do not think that allegations of Thor in those pleadings with respect to its inventory procedures at the end of 1963 in any way affect my decision earlier on the frivolity of the Petitioner's Reply, because I am not certain whether those allegations were prepared by prior management of Thor or present management of Thor. So, my ruling as to the frivolity still applies, but I will overrule Petitioner's objections as to those exhibits with that understanding.

Mr. Berens: Your Honor, could I have about 30 seconds to talk to the president of the company to establish the facts in my mind and see if I want to make a further point on this?

The Court: Certainly.

(Whereupon, a short recess was taken.)

[19] Mr. Berens: We have nothing further on that point, Your Honor.

The Court: Very well. The Stipulation of Facts, together with the Exhibits 1-A through 12-L, inclusive, Exhibits 13 through 18, inclusive, Exhibits M and N will be received in evidence and made a part of the record.

(The Stipulation of Facts and the documents previously marked for identification as Joint Exhibits 1-A through 12-L inclusive, Petitioner's Exhibits 13 through 18, inclusive, and Respondent's Exhibits M and N were received into evidence.)

The Court: May we have Petitioner's opening statement?

Mr. Berens: Your Honor, before I start that, I would like to ask Counsel for the Respondent if he was going to introduce certain other exhibits that he mentioned to us.

Mr. Sherman: Yes. I didn't know whether Petitioner's Counsel would prefer that I wait until Respondent's case, or if he prefers to have this done at this time, I would be glad to do so.

[20] Mr. Berens: I have no preference.

Mr. Sherman: Do you want these marked as Joint Exhibits?

Mr. Berens: Well, I am not sure what you have got right now.

(Whereupon, there was a discussion off the record.)

Mr. Berens: Why don't you mark them as your exhibits, because we have a partial competency objection to them.

Mr. Sherman: Okay. So, we have a total here of six. These would be Respondent's Exhibits for identification.

All right, these will be Respondent's Exhibits O—

The Clerk: O?

Mr. Sherman:—which is the 1963 Annual Report of Thor Power Tool.

Respondent's Exhibit P, which is the 1964 Annual Report.

Respondent's Exhibit O—

The Clerk: You just had O.

Mr. Sherman: I am sorry, Q, Respondent's Exhibit Q, which is the 1965 Annual Report.

Respondent's Exhibit R, which is the Form [21] 10-K, a copy of the Form 10-K, filed with the Securities and Exchange Commission.

The Court: What is the date on that one?

Mr. Sherman: That would be for the year 1965.

Respondent's Exhibit S, which is a Form 8 Amendment to this Report for the—also for the year 1964.

And Respondent's Exhibit T, which is the Form 10-K Annual Report filed with the Securities and Exchange Commission for the year 1965.

Respondent moves at this time for admission of the foregoing Exhibits O through T, inclusive, into evidence.

The Court: Does the Petitioner have any objection?

Mr. Berens: We have no objection to their admission, except for that portion of each of those exhibits which includes the opinion of the independent public accountants in the years involved and the related notes of the public accountants. In other words, that portion of each of those documents, that is

the work of the public accountants. This is hearsay as to Thor, and if the Respondent wants to put those portions in, he will have to put them in through a [22] witness who knows of their authenticity and will be subject to cross examination.

Mr. Sherman: If the Court please, these statements are essential parts of these documents. Furthermore, these accountants are the agents—the Petitioner's accountants, we are talking about now. These accountants were Petitioner's certified public accountants who Petitioner hired to make these statements, and, in fact, would not have filed these reports without having done so.

This is an amazing situation; Petitioner wants to repudiate its own public accountants.

Mr. Berens: It doesn't seem too amazing. Petitioner sued those public accountants.

Mr. Sherman: I would point out that the public accountants involved, the only public accountants who were sued, were its prior public accountants. It is apparently going to put on its present ones as witnesses in this case, but, in any event, I don't think that the Petitioner can fragment itself because of a change in management and say, "We are a new taxpayer. Let's start a new ballgame."

These are Petitioner's documents. These are statements by its authorized agents. They are part and parcel of those documents, and they are [23] admissible as admissions against Petitioner.

Mr. Berens: I think with respect, Your Honor, Counsel for Respondent is mixing two arguments here. We are not objecting to these documents insofar as they were the product of former management, these particular documents. We are only objecting to the competency of those portions which were prepared by the independent public accountants.

Now, Respondent, I think, misstates the relationship, the well-established relationship of independent public accountants to their client. They are not agents in the sense that the client

has direct power over them. In fact, that is the very purpose of the accounting profession and its role in preparing these opinions to the financial statements, it is independence. I don't believe that there is any authority, as well as any practice or general belief, that clients of independent public accountants can direct what is going to be in the accountant's opinion to the financial statements.

Mr. Sherman: Your Honor, they are agents in the very same sense that an attorney is an agent. They can't be controlled directly by the client, but they certainly have been retained by him and speak for him.

[24] The Court: Well, I take it these statements are not mere summaries of the books and records, is that correct?

Mr. Sherman: I believe they are, Your Honor. They purport to be. They make statements as to what has been done with respect to, among other things, inventory.

The Court: Well, I think in the normal course of—

Mr. Sherman: They are notes to the financial statements.

The Court: Well, that is true, but I think in the normal course of preparing financial statements, auditors may make adjusting entries to reflect—adjusting entries to the books to reflect certain things on the financial statements.

Now, if we are talking about such adjustments, I don't think those would necessarily constitute the books and records of Petitioner. Now, if they are a mere summary of the books and records of the Petitioner, they are hearsay, unless the books and records are in the Courtroom.

However, that objection I don't believe can be made by— I doubt if that objection can be made by Petitioner, because Petitioner controls the [25] books and records.

I think the exhibits are admissible in evidence, and I am going to admit them. I think—I fail to see how they cannot be competent evidence.

Mr. Berens: Your Honor, can I—before you finally rule on this, can I interpose an emphasis that I would like to make?

We are objecting to the competency only as to the opinion of the public accountant and the notes that he puts to his opinion. We are not—

The Court: I understood you objected to everything except the opinion.

Mr. Berens: No. I misspoke, then, Your Honor.

The Court: Or I misunderstood you.

Mr. Berens: No, we are not objecting to any portion of this except—maybe we can show you the portion in one of the exhibits, and it might make it easier to understand.

The Court: Is this a standard clause that is normally on the financial statement about the opinion of the accountants?

Mr. Berens: Well, it is a standard letter that is given incident to the public publication of the financial statements; that the accountants have [26] examined the books and records, et cetera, and that they are satisfied that they fairly reflect the net worth and the operations of the year.

Now, to be very specific in this case, one of these exhibits will involve the 1964 financial statement of Petitioner. Peat, Marwick & Mitchell, who had been its independent public accountants, audited that year's books and records.

At that time, at the time that they issued their opinion, they either were sued, or knew that they were about to be sued, by the client, and it must have crossed their mind in issuing that opinion that if they gave an unqualified opinion that the books and records were correct, that they would have admitted liability on themselves for failure to having adequately audited the books and records for prior periods. So what they did in '64 is they issued a qualified opinion questioning the accuracy of the year-end financial statements for '64 of the taxpayer and, in particular, in the inventory area, which was the area with which they were most likely to be found liable on a suit, so we have almost a classic example of a competency problem here.

If the Respondent wants to put in the opinion of Peat, Marwick for 1964, it seems to me [27] that they should call Peat, Marwick's partner who was in charge of that audit and establish the validity of that opinion as an exhibit, and permit us the normal thing of cross examining that witness as to just how independent and how accurate that opinion was that particular year.

We have not as dramatic but similar objections to the opinions of Peat, Marwick in '63, as well as '64, and to Price, Waterhouse in the annual statement for '65.

Although Price, Waterhouse at that time was not threatened with being a defendant in any suit, they were very definitely in the situation that they might be subpoenaed in the pending suit against Peat, Marwick, to testify.

The Court: Well, I think you have raised a question of fact about this statement about Peat, Marwick. I think it raises a question of fact as to whether Peat, Marwick did what it said in this printed opinion, and whether the opinion is valid, whether it is based upon reasonable approaches to the accounting method employed by the Petitioner, et cetera.

I will overrule your objection and receive these exhibits in evidence for the purpose of showing that these are the annual reports of the Petitioner, [28] and the reports contain these items.

Now, as to the opinion of the accountants, I don't think that it goes to prove the basis of their opinions, and I am not receiving it in evidence for that purpose. I am merely receiving it into evidence to show that the annual report contains a statement of the auditors, and it does not prove the truth or the correctness of the matters contained in the statement of the auditor. Is that understood?

Mr. Berens: Yes.

Mr. Sherman: I would point out that these are matters filed by the Petitioner. It wasn't filed piecemeal or in part. It was filed by the Petitioner, signed by the Petitioner's president in the case of the forms filed with the SEC, and I don't think that the Petitioner can have it both ways, to file a form and say,

"This is what we are filing, this is what we are stating to the federal government, to the Securities and Exchange Commission is our condition, but we won't adopt part of it," because if they said that, they wouldn't have been accepted by the SEC.

The Court: Well, I am sure of that, but I would imagine that the Petitioner relied on the opinion of Peat, Marwick.

Now, if Peat, Marwick and the Petitioner get [29] into a dispute about Peat, Marwick's competency to render these opinions or its errors in rendering the opinion, I don't think that is necessarily chargeable against the Petitioner.

I concur with Mr. Beren's views on the role of the certified public accountant. It is true that a certified public accountant is employed by a client to render a service, but one of the basic precepts of a certified public accountant is that his opinion is independent; that he is not under the domination of the client.

Within the Rules of the American Institute of Certified Public Accountants, there are even rules about an accountant having any financial interest in a client that the accountant examines, so I don't think that you can charge Petitioner with all the acts of an independent CPA firm.

Mr. Sherman: Do I understand that this limitation goes to the expressions of opinions?

The Court: Well, what else?

Mr. Sherman: What about expressions of fact? It appears to me that these people, in expressing, making statements of fact with respect to the financial statements, are speaking for the client, and if the client wishes to repudiate them, I think that the [30] burden is on the client to do so.

The Court: Are you talking about the statements by the auditors or statements by the Petitioners?

Mr. Sherman: Statements by the auditor. Statements of fact, now. I am not referring to expressions of opinion.

The Court: Where are those statements?

Mr. Sherman: The notes to the financial statements include facts, figures, with respect to inventory procedures. I don't

believe that these can be called statements of opinion, Your Honor.

Mr. Berens: Perhaps I can clarify this. We are not, and cannot, object to the notes to the financial statement which are the company's notes. We are objecting to the opinion of the accountants—and I have the '64—I don't know which exhibit number it is—but the '64 Annual Statement here,—

The Court: It is Exhibit P.

Mr. Berens: —and I refer to the second last page, where there is a pink bordered portion entitled "Accountants' Report," dated April 5th, 1965.

Well, in your Xerox copy it probably isn't pink. It is gray.

The Court: It isn't pink, but I think I have found the page you are referring to.

[31] Mr. Berens: And it is signed, "Peat, Marwick, Mitchell & Company." Now, there are similar accountants' reports in the other documents.

I also, before, in my objection referred to notes. I should have been more precise. I was not referring to notes on the financial statements, but I believe in the 10-K, the accountants' opinion has notes to it, and I was referring to any of the accountants' notes that are in those as contrasted with company notes which, of course, we are bound by, the company notes.

The Court: Does that clear it up, Mr. Sherman?

Mr. Sherman: Yes.

The Court. That is the way I understand the rules.

The notes to the financial statements by the company will be received for the truth of the matters contained therein. The notes by the auditors, or the accountants, to the financial statements and to the forms filed with the SEC will not be admitted for the truth of the matters contained therein.

Mr. Berens: With your indulgence, Your Honor, I would like to add one background comment.

In 1965, the SEC required Thor to restate [32] its financial statements. In fact, that is one of the exhibits introduced in evidence there, is that Amended 10-K.

Mr. Sherman: Form 8.

Mr. Berens: Form 8, was it?

Mr. Sherman: 8.

Mr. Berens: Form 8, it is an Amended 10-K.

If I recall correctly, that form is without audited accounts, and the reason—and this was at the time apparently unprecedented, the filing of a document with the SEC of a public company that did not contain an accountant's opinion, and the reason for this was the SEC concluded that Thor didn't have an accountant at that time that could certify. They were suing Peat, Marwick & Mitchell who was familiar with the accounts, and although they had engaged Price, Waterhouse at the time, Price, Waterhouse was not in a position to audit the prior year's accounts before their engagement, and so we had the situation at that time, Your Honor, where we had a public company without public accountants.

The Court: Therefore, Exhibit S, which is the Form 8, does not contain any statements by certified public accountants but, instead, it consists solely of statements by the Petitioner.

[33] Mr. Berens: Is that correct, is there anything by the accountants on that form?

There was not the normal statement in there. I am not sure if we can go as broad in your statement there, Your Honor, but we are doublechecking that.

Mr. Sherman: I would appreciate leave of the Court—these were received very recently from Counsel for the Petitioner, these particular copies which I have introduced, and they are my only copies. Since they are Respondent's exhibits, I don't imagine that they will figure prominently in the presentation of the Petitioner's case this morning. If they do, of course, they will be available. I would appreciate leave to withdraw them so that at the earliest opportunity, perhaps the first break, I can have them—I can have additional copies made for my own files.

The Court. Is that agreeable?

Mr. Berens: Certainly.

The Court: Very well. It is agreeable with the Court.

Mr. Berens: Your Honor, as far as we can tell, hastily going through that Form 8 of the Amended 10-K, there is nothing in that document from any public accountants.

The Court: Very well, if it does appear so [34] later during the course of the trial, you might want to bring it to the attention of the Court.

Mr. Berens: All right.

The Court: Exhibits O through T, inclusive, will be received in evidence and made a part of the record.

* * *

[84] Mr. Abrams: I would like to call Mr. Arthur Collins as the first witness for the Petitioner.

ARTHUR R. COLLINS, was called as a witness on behalf of the Petitioner, and, having been first duly sworn, testified as follows:

The Clerk: State your name and address for the record.

The Witness: Arthur R. Collins, 51 Baybrook Lane, Oakbrook, Illinois.

Direct Examination by Mr. Abrams.

Q. Mr. Collins, would you describe generally your principal business experience before coming to Thor?

A. After having many jobs during and after [85] school, my principal industrial experience began in 1942 when I joined Stewart-Warner as manager of the Heater Division at Chicago. Subsequently I became Chief Engineer of that Division and Manager of Research.

In 1944, the Heater Division was established as the Southwind Division, and the manufacturing and principal offices were transferred to Indianapolis, Indiana, and in 1945, I was trans-

ferred to Indiana, that is to Southwind Division in Indianapolis, as Manager of Engineering.

Subsequently, I was made Manager of Operations, which included responsibility for manufacturing as well as engineering, and in 1948 I became General Manager of the Division, and in 1957 was also elected a Vice President of Stewart-Warner Corporation. I held that position until December, 1964, when I became President of Thor Power Tool Company.

Q. Would you describe generally the products which Thor was manufacturing at that time?

A. Yes. Thor is an old line company. In fact, this is our eightieth year. Its principal business is what is called in the trade as hand-held power tools. In some respects this is a misnomer because many of the tools are so large you can't hold them in [86] your hands, such as large air-operated hoists which have a capacity of some 6,000 pounds, or large mechanically operated trowels for smoothing concrete. But generally, it is considered a hand-held power tool business.

In addition to this, Thor owns and operates the Cincinnati Rubber Manufacturing Company which is in the specialty rubber business, and at a small operation involving OEM, shaded pole electric motors.

In the Tool Division, we manufacture and sell air-operated rotary-type tools such as high speed grinders, drills, impact wrenches, nut setters, and this type of product. We manufacture a line of percussion type air tools such as paving breakers that you see them using in ripping up the concrete in the street, air-operated riveting hammers, and this type of product. We make electrically operated rotary tools such as the conventional drills, saws, impact wrenches, and this type of item. We make a line of electric vibratory type tools which are used in the construction industry for—in connection with pouring concrete. We have some gasoline engine driven tools like large power-driven trowels for smoothing concrete and large compactors for compacting the soil before you pour concrete.

[87] In the Rubber Division we manufacture belts for conveyor belting, a specialty hose, molded rubber products and also make the rubber covers for large rolls that are used in the paper industry, and as I mentioned before, the small electric motor operation makes shaded pole motors that are used by OEM manufacturers for such things as vending machines and this type of product.

Q. Are Thor's products sold to consumers as well as to these industrial users that you have described?

A. Yes. We sell these products generally to industrial accounts, contractor or construction type accounts, the service trade industry as well as the do-it-yourself. I am talking now about the tool business. The rubber part of the business is generally sold to industrial companies.

Q. In 1964, how many different manufacturing facilities did Thor have?

A. We had a plant in Los Angeles,—the Tool Division had a plant in Los Angeles, a plant in LaGrange Park, Illinois, a plant in Aurora. The rubber operation had a plant in Cincinnati and at that time we had another one in Natchez. We operate a plant in England in Tynemouth, which is near New-[88] castle, and one in Italy in Frossaco which is near Milan—I mean near Torino, excuse me.

Q. And what other locations was Thor maintaining inventories in 1964?

A. In 1964 we maintained, in addition to these plants, inventories at 23 service branches in the United States and one in Canada, and then we have a sales company in Mexico and one in Germany.

Q. And there were inventories of various products at each of these locations?

A. Yes.

Q. When were you first asked to take over the management of Thor Power Tool Company?

A. In August, 1964, Stewart-Warner, my previous employer, owned approximately 20 per cent of the share capital of Thor Power Tool Company, and at that time negotiated a purchase agreement with Thor to purchase most of the assets of Thor Power Tool Company.

This purchase agreement, among other things, provided for an audit and review of the assets and liabilities of Thor as well as the interim financial statements.

Shortly after that, the agreement was signed and I believe it was early September when Mr. Archambault, the Chief Executive officer of Stewart-Warner [89] Corporation, informed me that I had been selected to become the General Manager of what then was assumed to be the Thor Power Tool Division of Stewart-Warner Corporation.

Subsequently, during that fall, as a result of the audit and investigation that was conducted in relation to this purchase and sale agreement, the disclosures which resulted from this investigation were such that they clearly indicated that the assets of Thor Power Tool Company had been overstated, and the liabilities understated, and that the interim financial results were improperly reported.

In early December by mutual agreement between Thor Power Tool Company and Stewart-Warner Corporation, the purchase agreement was rescinded, and at the same time Stewart-Warner agreed to provide management assistance in order to try to restore Thor to a satisfactory operating position. On December 9, 1964 I was elected Chief Executive Officer of Thor Power Tool Company, and the Thor Board was expanded from nine members to 12, and I was elected a Director of Thor.

Mr. Archambault was also elected a Director, and another nominee of Stewart-Warner was subsequently elected a Director in January, 1965.

[90] Q. When did you first report to work at Thor as its President?

A. December 14, 1964.

Q. When did you begin working on the company's financial statements for the year ending 1964?

A. Almost immediately because of the disclosures which had been made prior to my becoming President, and the timing that it was close to the end of 1964. It was obvious that one of the first responsibilities I had was to prepare to issue the annual financial statements for Thor Power Tool Company in respect to the year 1964, and that to do this required a complete re-evaluation of the assets and liabilities of the company at that time.

Q. Were there particular aspects of the assets and liabilities to which you directed your personal attention particularly?

A. Yes. Partly because of experience, and partly because of disclosures which had resulted from this investigation, I concentrated on the three principal areas where a manufacturing company can get into difficulty. One is inventories; second are receivables; and, the third are accounts payable.

Q. With respect to the evaluation of the inventory, what types of inventory was Thor maintaining at [91] that time?

A. Well, in the Tool Division, Thor maintained inventories of raw materials, such as castings, forgings, steel bar, and this type of thing, in-process inventories, inventories of finished parts which were used for service, and also accessories which were sold as individual items, inventories of parts which were used to assemble finished tools, and other finished products; and, of course, the inventory of the finished tools and finished products.

Q. And at the Rubber Division?

A. The Rubber Division? Basically it was the inventories of raw materials, work in process and finished products.

Q. Would you describe the procedures which were followed in evaluating the Thor inventory at that time and before consideration was given to a possible excess inventory?

A. Well, the first thing we did was to make arrangements to have a physical inventory taken at all locations of the Tool Division and Cincinnati Rubber as of December 31, 1964. This physical inventory was then priced at 1964 inventory standards, and the priced physical inventory was reconciled to the book inventory, and the necessary adjustments made [92] so that these two figures would agree.

Q. After those preliminary steps, what major adjustments, if any, were made to inventory other than the adjustment for excess?

A. The first thing we did was to evaluate the method or the standards that were used in pricing the inventory, and in our opinion, the 1964 inventory standards at the Aurora plant were too high because they included excess costs due partly to small quantities, partly due to manufacturing inefficiencies. So we decided it would be more appropriate to utilize the 1963 inventory standards.

So the inventory was priced at the 1963 standards, and this resulted in an adjustment of $380,000, as I remember it.

Q. What kind of adjustment was that, Mr. Collins?

A. This would be a write down of the physical inventory by $380,000.

Q. What other adjustments, if any, were made before consideration of possible excess?

A. The next thing we did was to evaluate whether or not all of the items that had been inventoried should, in fact, be considered as inventory items, and we found that there were a great many that, [93] in our opinion, should not be. For example, there were demonstrator tools which had been used by salesmen as sales samples. There were some trial tools that had been in customers' places of business for many years. There were general supplies, stationery supplies. In one place, I remember there was even some lumber.

So we took all of these items, which, in our opinion, were not items which normally should be considered as being in

inventory, and these were written off, and the value of this write off was about $351,000.

Q. Were there any other adjustments made to Thor's inventory other than the adjustment for excess at that time?

A. Yes. The next thing we did is that we wrote off about $422,000 of damaged and unusuable tools. These were primarily consumer-type tools which had been returned from the customers that were defective, and were simply unsaleable. As a matter of fact, we had, as I remember, two or three trailer loads of them out in the back of the LaGrange Park plant. So these were written off.

The next step was to evaluate the inventory to determine what portions of the inventory would be [94] considered obsolete. This was a very extensive evaluation, and involved reviewing the models to see—or the finished products and tools to see whether or not they were active, to review the parts, and in many cases, we found that parts had been inventoried for products which had been developed but had never been offered for sale. There was a large quantity of parts for which there was absolutely no usage in 1964, and in those cases we considered that if there was no demand at all in 1964, that that item by definition, by our definition, was considered obsolete. And so we wrote off at that point all of the obsolete inventory, and I believe that amount came to about $1,603,000.

Q. What was the next step taken in connection with the valuation of the year-end inventory of 1964?

A. Well, at this point we felt we had what would be considered a usable inventory item by item. But we then had the task of determining whether or not in this inventory there was excess, and because of the disclosures which had been made prior—I mean associated with this purchase-sale agreement, and because of the visual observation of just going through the plant and observing the physical inventory and relating this to the sales figures, and because of the type of business we were in, it was readily [95] apparent that we had excess inventory.

Q. What aspect of the nature of your business led you to that conclusion?

A. Well, it is our experience that any business which is involved with manufacture and sale of products inevitably must have excess inventory, and one reason for this is the fact that any errors that occur in the day-to-day operation of the business, any estimates of future sales which are wrong, any of these errors which tend to create excess inventory are not offset by errors of judgment or whatever they may be in the other direction. In other words, any error that occurs, or a situation that occurs in the day-to-day operation of the business which results in an insufficient inventory, is automatically corrected by buying or making additional inventory; whereas, those events which result in excess inventory are not offset by these. So the net result of the day-to-day operation of the business is one which will have excess, and unless you operate a business, unless in your operation of your business, you must dispose of this excess currently as, for example, a grocery store does with the produce that they buy because it won't keep, so they have to dispose of it currently. If you don't have this kind of operation, you are bound to [96] have excess.

Secondly, the kind of business that Thor was in is one which involves a very high percentage of service parts and accessories, and by "accessories," I mean the attachment and devices such as drill bits and moil points and steels that are used with the tools. In fact, in 1965 over 30 per cent of our sales were in service parts and accessories. And having a large service parts business, and since a signicant portion of our business was in the industrial and in the construction field as well as the consumer field, it is absolutely essential to have service parts available where and when the customer needs them. You can't wait and manufacture service parts when somebody needs a service part. Likewise, you tend to manufacture and should manufacture these parts in reasonably economical quantities.

In addition, as I mentioned a moment ago, in estimating our sales and providing the service parts for these sales, there are going to be—you aren't going to estimate with 100 per cent accuracy, and when you estimate that the sales are going to be less than they are, you have to manufacture additional quantities in order to be able to meet that service demand. So the net result is that with your [97] service parts business particularly that—but this also applies to other portions of the business—you will inevitably have larger quantities of inventories than you can sell at any one time.

Q. You mentioned that you wanted to produce parts in economical quantities. Would you explain that?

A. Yes. The—in manufacturing parts, you have a certain fixed cost for a lot of parts, the cost of setting up the machines, the cost of processing the order, if you will, the costs which are independent of quantity, and you also have the cost which varies with quantity such as the cost of carrying inventory and things of that nature. Now, if you equate these two, there is a quantity for any given demand, if you will, that represents the most economical quantity that one should manufacture.

The difficulty is that such an estimate must, of necessity be based on your estimate of what you are going to use, and, therefore, it is not precise.

Q. What conclusions did these factors lead you to reach in determining the procedure to be followed with respect to the audit of Thor's inventory and the evaluation of it at the end of 1964?

A. Well, we concluded that there was a signifi- [98] cant excess inventory, and that it would be necessary, in our opinion, to attempt to evaluate the extent of this excess in order to properly effect the value of the inventory at the net realizable value, or market value, because while you have all these parts, and that a certain percentage of them will be used, then it is uneconomic to throw away those that you won't use because you don't know which part it is. This is the problem. If one knew,

there would be no problem, but you can't forecast. Therefore, you—it is improper, in our opinion, to value the entire inventory on the same basis as you would if you knew you were going to sell it because you know that a certain percentage of inventory is not going to be sold.

Q. What procedures were undertaken by Thor at that time to determine the amount of write down to make?

A. Well, the first thing we did was to—by reviewing the inventory to determine if there were any very large identifiable products or groups of parts that might be evaluated individually, and this we did, and we found that there were three models basically that had been introduced in recent years which were the—where the actual sales had been greatly reduced or were much lower than anticipated. [99] In fact, one of the products was a product we decided to get out of the business of. It was an oil-fired space heater which Thor had manufactured, and so our first move in trying to evaluate the excess was to take the inventory of parts for these three products, the space heater, and E-700 rotary saw, and E-800 drill, and these parts were evaluated separately and a separate adjustment was made to the inventory for an excess of I think $245,000.

Q. What procedures were followed with respect to the remainder of Thor's inventory in determining the amount of write down for excess?

A. Well, the remainder of the inventory was represented by some 44,000 inventory items, and because of the number of items, and the relatively modest quantity of any one item, we decided that it was impractical to try to evaluate the potential market, if you will, for each item individually, and yet we faced this problem of trying to relate the inventory to future usage or sales because I think it is pretty obvious that if you have an item in which you have, say, $100 worth of inventory that represents a 10-year supply, that that inventory, as compared to $100 worth of inventory that represents a year's supply, the inventory that represents 10 years' supply has inherently [100] less value

because of the things that can happen to the inventory. Some of it will be lost. Some of it may become damaged. Some of it will become obsolete because of the technological change. Some won't be sold because of the fact that you have market changes. So we were confronted with the problem, as anybody in the manufacturing field, of trying to develop a relationship between inventory quantity and anticipated usage.

So here is where I fell back on my experience of 20 years in manufacturing of trying to determine a reasonable basis for evaluating this inventory. In my previous association, we had generally written off inventory that was in excess of one year. In this case, we felt that that would be overly conservative, and it might understate the value of the inventory. On the other hand, we felt that two years—if we wrote off everything over two years, that this would be too optimistic and that we would overvalue the inventory because there is—once again, if we look at—consider the factors which affect inventory, such as technological change, market changes, and the like, that two years, in our opinion, was too long a period of time.

So what we did is we came up with a formula [101] which was somewhat in between valuing writing off, say, everything over one year as compared to writing everything over two years, and we came up with this formula that has been referred to in this Court today. We valued the first year's supply at 100 per cent; the next six years—six months' supply at 50 per cent; the next month's—six months' supply at 25 per cent, and everything over two years, zero. This was the formula we used.

Q. How did you determine what one year's supply or two years' supply would be for each item?

A. Well, in 1964, the only information available to us was past performance. When I came to the company, there was no budget or forecast for the ensuing year, so the only information available was past usage. So what we did was, we—in the case of service parts and accessories, we took the previous 12 months' actual usage as a basis for models, and we used the previous—in other words, 1964 actual usage as a basis.

Q. By "models," you are referring to what, Mr. Collins?

A. I am referring to complete tools and other completed products. In the case of parts for—used in manufacturing the finished products, we used our— [102] the quantities that were used in production in 1964. In other words, we used production usage, not sales usage. For work—for work in process, we used the production usage, and also for raw materials. So we used a combination of both actual sales and production usage for 1964 in valuing the inventory at December 31, 1964.

Q. Mr. Collins, I would like to show you a document that has been previously marked for identification as Petitioner's Exhibit 21, and ask you to examine it, please.

(Document tendered to the witness.)

By Mr. Abrams:

Q. Have you had a chance to examine that, Mr. Collins?

A. Yes.

Q. Was that tabulation prepared at your supervision?

A. Yes, it was.

Q. Are these statistics on here taken from the records of Thor Power Tool Company or are these merely the—

A. These are simply representative figures. They are not taken from any records of the company.

Q. The designations in the left-hand column, [103] Items A through E, are not purported to represent any specific product of the company?

A. No.

Mr. Abrams: If the Court please, I would like to offer this in evidence as Petitioner's Exhibit 21.

Mr. Sherman: Well, now, I did not catch this. Has this been marked in identification or offered in evidence?

The Court: It has been marked for identification as Petitioner's Exhibit No. 21.

Mr. Abrams: I am offering it.

The Court: Do you have any objection?

Mr. Sherman: Yes, Your Honor. It is really not evidence. It is a hypothetical illustration of how the formula which we have stipulated in Paragraph 9 of the Petition would happen to work in that, you know, given these particular hypothetical figures. Now, I would have no objection to this going into the record merely for the purpose of aiding the Court as a summary of what this Petitioner may testify to, or to aid the Court in evaluating what Petitioner wishes to bring out in terms of how this formula works, given these assumed facts and those assumed facts. That is all it is, though. It is simply hypothetical [104] information of how the mathematics on this formula works out. Given different facts, and for that purpose, for that limited purpose, I have no objection. But I do not believe it would be admissible as evidence in chief for any greater purpose than that.

Mr. Abrams: That is the only purpose for which it is being offered.

The Court: I understand. It is being offered to demonstrate the purpose of the formula and clarify the formula with respect to items in that nature.

Mr. Sherman: I was sure it was offered for that limited purpose, but just in order to clarify the point, and with that limitation, I still have no objection.

The Court: Very well. With that understanding, Petitioner's Exhibit 21 will be received in evidence.

Let me ask you at this point: Do you intend to offer 19 and 20?

Mr. Abrams: Not through Mr. Collins, your Honor.

The Court: There will be Exhibits 19 and 20?

Mr. Abrams: Yes. These were numbered in the order in which they were prepared.

[105] The Court: That is all. I just wanted to be sure we did not skip a number.

Petitioner's Exhibit No. 21 will be received in evidence.

(The document previously marked for identification as Petitioner's Exhibit No. 21 was received into evidence.)

By Mr. Abrams:

Q. For purposes of clarification, would you explain—directing your attention to Item A, explain what the other numbers on that line represent with respect to that example.

A. Yes, starting from the left and going to the right, the second column represents an assumed inventory of 100; the next column represents an assumed 1964 usage of 20; and then as we proceed, to the right shows how the write down would be determined, using the formula which was used.

For example, 0 to 12 months projected usage would be 20, and there would be no write down on that quantity.

The next, from 13 to 18 months' usage would be 10, and that would be written down to 50 per cent, or 5.

[106] The 19 to 24 months' usage was 10, and that would be written down 75 per cent, to 7.5, and the remaining 60 units would be—which was beyond 24 months' requirement, would be written down 100 per cent, to 60, making a total—if you add up the third line—making a total write down for that particular item of 72½ per cent.

Q. Are the numbers shown in this chart, for example, B, C, D and E, computed in the same manner?

A. Yes, they are.

Q. In applying the formula which you have been describing, was that also applied to the three types of items which you said were written off, specifically in the amount of $245,000?

A. No, we did not apply this formula. They were written off on an individual judgment basis, that is, by evaluating those items as such. No formula was applied.

Q. Then that was one category write down for excess and the formula was second?

A. That is correct.

Q. Was there any other write down for excess applied to the inventory as of December 31, 1964?

A. Yes. We had two locations, one at Cincinnati Rubber and the LaGrange Park plant Tool Division. [107] There were certain classes of inventory where past usage information, we felt, was inadequate to properly evaluate the net market realizable value of that inventory, and so in addition to the formula, in some cases, we reviewed those inventories by class and made a determination of the additional reserve which we felt was necessary in order to reduce the value of those items of inventory to the market value.

Q. What was the amount of that supplemental write down?

A. $160,000.

Q. In determining to make the three types of write downs for excess that you have described as of December 31, 1964, what factors influenced you to make that decision?

A. The primary factor was an effort to state the book inventory at a figure which would represent the net realizable value. There was no consideration given to any other factors.

Q. Including income tax consideration?

A. Income tax considerations were not considered at all at that particular time.

Q. I am referring not only to the adjustments for excess, but also the other inventory adjustments that you have described for obsolete, for damaged, the [108] adjustments relating to the standard cost change and the adjustments for items such as supplies and demonstrators. Were all of those adjustments charged against 1964 tax and income?

A. Yes, so far as the 1964 income tax return is concerned, that is correct.

Q. Now, after writing down these items by virtue of the credit to the reserve for excess, what efforts were made to dispose of the excess spare parts?

A. Very little effort, because there is almost no market other than the normal market through normal channels for service parts. Nobody has any use for a fender for a 1967 automobile except somebody who has a 1967 automobile that needs a fender. So there is no market for service parts, generally speaking, and therefore we made no effort except through the normal channels—normal prices to sell the service parts inventory.

Q. A price reduction would not have increased the market for such products?

A. In our opinion, no, because only—once again, it doesn't make any difference how cheap the service part is. If you don't need it, you won't buy it.

Q. What efforts, if any, were made to dispose [109] of finished tools in the excess category at reduced prices?

A. In a few cases, where the quantities justified, we lowered the price and sold the inventory. This was true of the completed space heaters, for example, as with the E-700 saws. But, in the case of most of the finished tools, the quantities were quite small, and in many cases the markets for the type of tool we manufactured, particularly for industrial and construction fields, is very limited. So there is no really very feasible or economically sound way, let's say, to sell the excess inventory except through normal channels.

As a matter of fact, if one were to lower the price and try to sell some of those items, we might have less net income than if you didn't lower the price.

Q. What efforts were made to dispose of the excess work in process?

A. The excess work in process is very much like service parts. Nobody has a need for a partially completed part. There is no market for it except as scrap.

Q. What efforts were made to sell the excess raw materials at reduced prices?

[110] A. We did make an effort to try to sell some of the excess raw materials, but these efforts were met with very little success because, while there is, one would think, a market for general purpose raw materials, excluding, obviously, castings and forgings, which are unique to our products, but you might feel there is a market for bar stock or hardware items, such as nuts, bolts, screws and washers, but as a practical matter, the most likely customers, namely, other manufacturers who use these products, are really not interested and are not receptive to buying these products because even though they could buy them, perhaps at a lower price, they are unwilling to take the added risk which is involved in buying products from another manufacturer. You are not sure they meet the specifications you have and, also, where the manufacturer would have no recourse.

So, as a practical matter, except for a very few items where the quantity was large enough to justify the expense, there is no market—at least that is our experience—no market for the raw materials and hardware items.

Q. How did Thor account for excess inventory in the years after 1964?

A. We have followed, since 1964, the same basic [111] policies and principles in evaluating our inventory, including the determination of excess inventory.

However, while we followed the same basic formula, we have improved and refined the technique for determining the usage, and currently we are using—instead of using exclusively past performance, we are using forecasts of future usage, modified by past usage, and I can explain that in greater detail by item in the case of models.

We use our forecast there, that is, our budget for the ensuing year, in order to determine the probable sale of models or finished tools, finished products. The same is true of accessories.

In the case of service parts, we use past usage as a basis, however, modified in the total, to take into account the level of service parts sales we expect to achieve in the coming year.

Q. Except for that adjustment in computing usage, computing in a slightly different manner, has the formula been applied in the same way, in other words, 100 per cent for one year and 50 for the next six months, and so on?

A. Yes, it has.

Q. What consideration is given to subsequent scrapping of items, scrapping in 1965 of [112] items that were reserved against as excess at the end of 1964?

A. When we scrap an item during the year, the inventory of value of that item is charged to the reserve, and the inventory is reduced.

In other words, if we scrap $100,000 worth of material during the year, the inventory is reduced by $100,000, and the reserve is charged by $100,000—charged with $100,000, which would reduce the reserve by $100,000.

Q. And when you make the computation at the end of the year, those items are already out?

A. That is correct.

Q. Is there any special treatment for items which you sell which have been reserved against as excess? That is, if sales are much greater than expectation for a particular item?

A. There is normal sales. In other words, sales to normal channels and products are handled in exactly the same way, regardless of whether they have been reserved against or not. If they are sold as scrap, it would be different, as I have already indicated.

Q. In addition to those formula adjustments in the years after 1964, were there special adjustments [113] similar to the ones made at the Cincinnati and LaGrange Park plants in 1964?

A. There have been no special adjustments of the same type that we applied in Cincinnati and LaGrange Park—namely the type of adjustment we felt was necessary because of inadequate records or information. There have been, in one or two years, some special adjustments in addition to the formula adjustment reserve.

Q. What effects have those adjustments had on the taxable income of particular years?

A. Well, in 1971, which is the one I [remember] particularly, the reserve for excess inventory was reduced by slightly less than $100,000 because we felt that the formula, when applied to a new product, and the inventory of parts that we had for that product, overstated the reserve, or in other words, understated what we felt would be the net realizable value of

that inventory. So, after applying the formula, we made the special adjustment to the reserve, reducing the amount of the reserve for excess by something less—if I remember, it was $97,000.

Q. What effect did that have on taxable income for that year?

A. That would have increased—that would have [114] reduced the cost of sales in that year by $97,000.

Q. In the increased taxable income?

A. That's correct.

* * *

[121] Q. In applying those procedures, what—in [122] the years after 1964, what consideration was given to Thor's profits in any year?

A. Absolutely none. In fact, one of the benefits we feel in using the formula approach, where, as I mentioned a minute ago, the usage is governed by our sales forecasts and budgets, which are prepared in advance of the inventory, that there eliminates—by following this rigorous approach, it eliminates any tendency that anyone in the company might have to adjust the inventory evaluation based on some desired financial results.

Q. Were these tabulations relating to all of Thor's inventory, or only to its domestic inventory?

A. These relate only to the domestic inventories and, with one exception, Canada. We regard Canada for this purpose as part of our domestic operation. That's what we consider it.

The Tool Division, for example, includes our Canadian branch.

Q. Your Canadian branch is part of the domestic company?

A. That's right.

* * *

[123] Q. In the years after 1964, did Thor undertake the same kind of inventory audit and evaluation in all respects as it did in 1964?

A. Yes, we did. Each year we have gone through the same basic steps which I described with respect to what we did in 1964. And with respect to the excess, we recomputed the required reserve from using the basic inventory date. Taking the latest usage data, we computed the reserve required and then adjusted the balance in the reserve up or down, depending upon the required reserve that is necessary to reduce our inventory to what we believe is total net realizable value.

Q. When items are scrapped during the year, what effect does that have on the reserve provision for those items?

A. If we were to scrap, say, $100,000 worth of parts during, say, 1972, the physical—the book [124] inventory would be reduced by $100,000; the reserve would be reduced by $100,000, and then at the end of 1972, since those parts wouldn't be on hand, there would be no need to reserve against them. This is the way we handle disposal of any item which has been reserved against.

Q. In effect, it reduces the cost of sales for that year?

A. That is correct.

Q. Mr. Collins, I would like to show you a document which is already in evidence as Petitioner's Exhibit 13, and ask you to examine it.

(Whereupon, said document was tendered to the witness.)

By Mr. Abrams:

Q. Mr. Collins, are the computations on Exhibit 13 the adjustments you described as having been made in LaGrange Park and Cincinnati, the amount being $160,000?

A. Yes.

Q. And the Speedway designation on here is the name of the LaGrange plant?

A. It was called Speedway Division at that time, but the plant is located in LaGrange Park.

Q. Would you describe the manner in which the [125] $160,000 additional adjustment reflected on Exhibit 13 was computed?

A. What we did, the inventory we had, for example, at Speedway, as indicated here, was divided into several categories with the gross usable inventory value for each category, and by examining these values and the—what we feel to be a desirable reserve against them, we select appropriate percentages for each class of inventory.

Admittedly, this is not a precise way of doing it, but we felt some adjustment of this nature was in order, and these figures represented our best estimate of what was required to reduce the inventory to net realizable value. In the same way, we used the formula. This obviously is not an exact or precise science, but the formula was selected to give us what we believe to be a result representing the net realizable or market value of our inventory.

Mr. Abrams: I have nothing further, Your Honor, with respect to the inventory issue with Mr. Collins.

The Court: Would you like to cross examine?

Cross Examination by Mr. Sherman.

Q. Mr. Collins, I take it you are familiar with [126] the fact that Thor was engaged in litigation beginning in 1965 in two different lawsuits in the Federal Court. Are you familiar with that fact, sir?

Mr. Abrams: Your Honor, this line of interrogation is certainly outside the scope of Mr. Collins' direct examination. I object to it for that reason.

Mr. Sherman: I will demonstrate in connection with what I am speaking—I will ask him certain questions with respect to allegations made.

The Court: I cannot recall whether he testified about the lawsuits or not. He testified about the revision of the contract at Stewart-Warner.

Mr. Abrams: He did not testify about the lawsuit. Mr. Berens made reference to them in his opening statement, and

we had argument on admissibility of the pleadings from those cases.

The Court: I think I will sustain the objection. Of course, you can always call this witness as your witness, but I think it is not proper cross-examination.

I will sustain the objection.

By Mr. Sherman:

Q. Mr. Collins, I believe you testified that you came to Thor, was it late in 1964?

[127] Approximately what date in 1964?

A. I was elected President December 9th, 1964.

Q. And was this part of an effect of a new management team coming in to organize?

A. This was the result, as I stated in my testimony, that the rescision of the purchase agreement that had been entered into between Stewart-Warner and Thor, and Stewart-Warner's agreement with the Directors of Thor to provide management assistance to Thor.

Q. And was it contemplated that as a result of this management assistance, various changes would probably be made in the operations of the Thor organization?

A. Yes, I think that would be a fair statement.

Q. Would it be a fair statement to say that there probably would be changes in the management and selling policies of the organization?

A. It is possible. It doesn't necessarily follow, it seems to me.

Q. Well, let me put it another way.

Would it be safe to assume that the manufacturing and selling policies which had been previously carried on would necessarily be continued into the future?

A. I don't think that. What was really agreed [128] was simply to provide additional management talent. There was no specific thought or direction as to—on the part of Stewart-

Warner or the directors of Thor as to what the result would be by the change of management.

Q. But this new management would be a free—would be considered free to adopt new policies?

A. Yes.

Q. And some of these policies, could I assume, differ quite radically from policies followed by its previous management?

A. Yes.

Q. Now, when you came into the company, did you anticipate that Thor would go out of business within, say, the next two years?

A. Absolutely not.

Q. Did you anticipate that all of its current tools would be discontinued within the next two years?

A. I didn't anticipate that, no.

Q. Would it be safe to assume that in all probability, and perhaps most of its currently produced items would still be produced two years from that date?

A. Not necessarily.

Q. Would you say, then, that it would be [129] entirely speculative to assume one way or the other as to whether current production would continue or be discontinued, to any degree?

A. I think it would be speculation. Certainly it would have been on my part, since I was completely unfamiliar with Thor's operation, except in a broad way.

The Court: Let us stop here for a moment for a change of reporters.

(Whereupon, there was a short interruption.)

By Mr. Sherman:

Q. Mr. Collins, in projecting future trends, is a one-year period a sufficient period of time on which to base such projections?

A. It depends on for what purpose.

Q. Well, let's assume that the new management has come to take over direction of the company.

Would the sales of the immediately previous year under the prior management be an adequate basis on which to project what would happen under sales of new management?

A. If it was the only information available, it would have to be used for this purpose.

Q. Would you agree that such a projection would be purely an estimate?

[130] A. Any projection is an estimate.

Q. Do you believe that any item of inventory which would not be sold within two years is absolutely worthless?

A. If it isn't going to be sold within two years and there isn't any market for it, the probability of it having any value is very limited.

Q. Suppose there is a market, there are actual sales within the past, and there are anticipated sales in the future, but this happens to be—

A. There is no guarantee that there is a market for anything, at least in our business.

Q. In other words, unless there is a guarantee that it will be sold, you consider it worthless?

A. On the average. Our evaluation of the inventory, one has to recognize, is done in such a way as to arrive at an overall reasonable value. Because of the inaccuracies of forecasting, it is inevitable that some of the items we assign full value to are in fact worthless. In retrospect, that is in actuality, they are worthless because the sales we are anticipating we were going to have don't materialize. Now, it is equally true that some item we assume is not going to be used is used.

But, the objective of our system is to have [131] an objective consistent fair basis of evaluating the probable market value of excess inventory.

Q. Then as to any given item, this particular procedure could prove to be quite inaccurate, couldn't it, just taking that item alone?

A. Certainly, for an individual item.

Q. Taking this procedure, let's take a hypothetical item, an inventory item which has been carried at $1 per unit prior to December 31, 1964.

Let's assume that there are 200 units on hand as of that date, and that 1964 usage was 100 units.

Now, would the total inventory figure for that item immediately before application of this procedure have been $200?

A. Would you mind repeating those numbers?

Q. Let's assume that the item has been carried at $1 a unit. There are 200 units on hand as of December 31, 1964. 1964 usage was 100 such units; that there are 100 units. It is apart from the 200 that are now left in inventory.

Would the inventory figure for that particular item, the total inventory figure immediately before the adjustment pursuant to these usage procedures, would that be $200?

A. Just to make sure I understand your question, [132] if we didn't make or buy any inventory, you are assuming that—say there were 300 units in inventory at the beginning of the year.

Q. That is correct.

A. We sold 100 units and we have 200 units left.

Q. Yes.

A. Now, if this were usable item—in other words, not obsolete, not damaged, was an item that properly should be in inventory, the gross usable inventory value assigned to that item would be $200.

Q. And what would the inventory figure for that item be following the December 31, 1964 adjustments?

A. The gross inventory would remain unchanged. The reserve against that inventory to arrive at a net inventory value, if we had the 100 units—pardon me. My arithmetic is kind of

slow—would be $137.50, if my arithmetic is correct. That would be the net. The reserve would be $62.50, and the net value after deducting the reserve to get—to reach the net realizable value would be $137.50, if my arithmetic is right.

Q. All right. Now, if we assume the same facts except that there are 1,000 units on hand as of December 31, 1964, what would the net inventory value of that 1,000 units be?

[133] A. Is the usage the same?

Q. Yes. 100 units in '64.

A. The net value would be $137.50.

Q. All right. Would the same net value be true if there was a million units in inventory?

A. That is correct. It would also mean we would have a few hundred years supply. I don't know what the arithmetic is, but on that basis of a thousand, we would have a 10-year supply, so if it were a million, I won't live long enough to worry about it.

Q. Well, let's take a slightly better selling item. Let's assume we have an item in which there are 10,000 units in stock as of December 31, 1964; that is, 10,000 after whatever was constituted in 1964 usage. 1964 usage is 100. This would be also carried in inventory originally and up to the end of 1964 at a dollar per unit. So, you would have a total preadjustment figure of $10,000.

Now, from what you have testified previously, I think we can agree that the net inventory figure as of December 31, 1964 following this adjustment would again be down to $137.50, is that correct?

A. Other things being equal. I mean it being a usable item and so forth and so on, yes.

Q. Now, if we assume that no more such units are [134] acquired or made or produced during 1965, but usage is 2,000 units, what would the net inventory figure be as of December 31, 1965 for this item immediately before and immediately after application of those procedures?

A. In 1965, you say we sold 2,000?

Q. Correct. And assume that they were sold at a dollar apiece, to make it simple.

A. So we now have 8,000 left in inventory?

Q. Correct.

A. And it still has an inventory value of a dollar apiece?

Q. No. It had that value prior to December 31, 1964. I assume the net value has been written down as of the end of the year.

A. The way we handle that, that unit continues to value in the gross usable inventory at a dollar, if we don't change the standard. So that the gross usable inventory at the end of 1965 would be $8,000.

We would then determine a new usage and reserve figure, and in this case, the 2,000 units that were sold in 1965 would be the new base for computing the future usage, so, now, in the case that you cited, the 2,000 of those units would be valued at future value, 1,000 would be valued at half that value, which [135] would be 500, and another 500 would be valued at a quarter, which I guess is 125, so we would have $2625, would be the net value of this usable inventory, and the reserve would be the difference between that and $8,000.

The Court: Could it be 2725?

Mr. Allen: I have 2750. I think the last 25 per cent would be 250.

Mr. Sherman: That was my figure also.

The Witness: Yes, I am sorry. My arithmetic is in error. So the net figure would be $2750, and the reserve would be $5250.

Mr. Sherman: Right. Excuse me?

The Witness: And the reserve would be $5250.

Mr. Sherman: That is right.

By Mr. Sherman:

Q. Now, in terms of the tax returns, though, the net figure would be the figure that would ultimately be reflected in the cost of goods sold, isn't it, in the closing inventory figure?

A. Would you repeat the question, please?

Q. In terms of the—in terms of the tax return, the income—Federal income tax returns, I take it, it is the net figure that is ultimately reflected?

[136] A. That is correct.

Q. In the closing inventory?

A. That is correct. Also the net figure is used in the opening inventory.

Q. Now, going into 1969, let's assume that there is no usage at all. The usage is zero on this item, so we will have the 8,000 or the—we still have the 8,000 units remaining at the end of 1969.

Now, would you give me the net inventory figure for these units before and after the adjustments?

A. If there was no usage in 1964, this item is to be considered an obsolete item.

Q. And I take it, then, it would be written off the book?

A. Written off and disposed of.

Q. And now, if in 1967, some usage did occur, would the amount of such usage then result in a—in putting this back into inventory?

A. Not if we already disposed of it.

Q. In other words, you are saying if there was no usage, it would be scrapped?

A. If no usage, it would be considered obsolete; the chances are excellent that it would be removed from whatever catalog or price list that the item [137] would be for sale on, and we would dispose of the inventory and wouldn't have any further demand.

Q. Are inventory items ever carried over to a subsequent year despite an absence of any usage within the immediate one-year prior period?

A. I don't doubt that there are; that we don't get around, if you will, to scrapping them all.

Q. And if that is what happened with this particular item, and for some unaccountable reason the demand arose again in 1967—and let us assume that such demand produced sales of

4,000 units—how would that be handled on the books as of December 31, 1967?

A. We would have just like any other item, as I explained earlier. We go through this complete evaluation process each year so that in the event that the unlikely occurrence that you mentioned—having an item that has no usage in one year and a high usage in another—if this should occur, then obviously, applying our formula, if we had the 4,000, they would be valued—if we started at eight, we would only have four left.

And if the sales in the previous year would be four, the 4,000 would be on the books at full value.

Q. That is, the remaining item would be revalued at $1 a unit?

[138] A. That is right. As long as we haven't changed the inventory standard.

And the reason we do that is because as we make sales, we stay with a given inventory standard for that kind of approach because the item that we sell, we sell at normal prices.

Mr. Sherman: I have no further questions.

Mr. Abrams: No redirect on the inventory. Mr. Allen will direct as to bad debts.

The Court: I have two questions to ask on the inventory issue.

Were your sales of tools made direct to the ultimate consumer or were they made through jobbers or distributors?

The Witness: In 1964, we sold tools. We sold both ways. In some cases, they were sold directly to the industrial accounts. We are talking now about industrial tools.

We would sell, for example, to Ford or Chrysler or Caterpillar or any of the large companies in these certain areas. In other areas, we sold through industrial jobbers or distributors.

In construction equipment, like the breakers for paving, and this sort of thing, we sold through distributors. Likewise, the consumer type products, [139] the do-it-yourself products, we sold through distributors.

The Court: Did jobbers or distributors maintain inventories to replace parts, or were replacement part requests made directly to Thor?

The Witness: It works both way. The parts for the construction tools generally were sold through the construction type distributors. The type of distributors that you use in market tends to have service facilities.

In the industrial field, some of the distributors handle service parts, but a great many parts were sold through our branches directly to the consumer. Other parts were used by our branches in repairing tools that would be sent in for repair.

So there was an inventory of service parts, both in the branches, in distributor places, as well as in some of the large industrial accounts. I mean, companies like Ford maintain a significant inventory of parts. This is one of the added problems, and because of the long pipelines in essence that you have, this larger inventory in the field, we frequently at the factory—our knowledge of sales tends to—sales of parts tend to lag the actual event.

This is one of the tendencies and one of the [140] reasons that we do have quite a lot of what turns out to be a lot of excess inventory.

The Court: Did Thor know what inventories of replacement parts were by the distributors or jobber?

The Witness: No. No, we don't have any good data of that kind.

The Court: I have no further questions.

Mr. Sherman: I just have two more questions.

Cross Examination (Resumed) by Mr. Sherman.

Q. Now, when these items were written down on the basis of no write down of an amount equal to '64 usage, and then the 50 per cent and 75 per cent write downs and write offs, was there any actual physical difference between—between various

units of these items so that you can distinguish one that was written down completely from one that was not written off at all?

A. Not until they were physically disposed of in the case of, say, obsolete items and something of that nature.

Q. Just one further question.

Did Thor enter the home appliance field in 1961—

[141] Mr. Abrams: There is nothing about 1961 in his direct examination, and the year is also, I think—there is nothing claimed with respect to anything done in '61.

Mr. Sherman: Your Honor, I think this goes to the question of the likelihood of the use, possible increased need for replacement parts, accessories, which apparently was the greatest part of this inventory.

The Court: I think it is beyond the scope of direct examination.

Mr. Sherman: I would be willing to make the witness my witness for that one question, Your Honor.

The Court: Very well.

By Mr. Sherman:

Q. Did Thor enter the home appliance field in 1961?

A. What do you mean by "the home appliance field"?

Q. Oh, toasters, home lawnmowers, the types of small appliances used in and around the home?

A. As far as I know, Thor has never been in the toaster business.

Q. I am just using that as an example. That is [142] an example.

That may not be a specific—

A. We have not been in what I would call the home appliance market.

Q. Well—

A. Now, Thor has made a lawnmower, and I can't tell you when they started to make it. I just don't know.

But of the products you mentioned, the only item that I know of that Thor has manufactured and sold is an electric-powered lawnmower.

Q. Did Thor enter a new—what it considered a new field in 1961, a new type of body?

Mr. Abrams: Your Honor, if Mr. Sherman wants to undertake a lengthy examination of Mr. Collins as his witness, okay. But this is not the time for it.

Mr. Sherman: This will be my last question.

Mr. Abrams: I withdraw my objection.

By the Witness:

A. I am not quite sure what Thor did in 1961, and I don't recall the date that Thor acquired the Speedway Manufacturing Company, and the Speedway Manufacturing Company was the company that was in largely the do-it-yourself type of hand-held power tools.

I don't know if this is what you are referring [143] to or not, but I am not personally familiar with what Thor did in 1961.

Mr. Sherman: Thank you.

Mr. Abrams: Nothing further on the inventory issue, Your Honor.

The Court: Very well.

Direct Examination by Mr. Allen.

Q. Mr. Collins, turning now to the bad debts issue in this case, you testified earlier today that upon becoming President of Thor, one of the assets of the company that you felt perhaps might present a problem and that required review was the accounts receivable.

Would you expand on that and explain?

A. Yes. As I mentioned earlier—

Mr. Sherman: Your Honor, I am going to object to that. This is such a broad question I really don't know what they are

getting into, and I think that the witness should be—should have questions posed to him, and he could answer those questions.

Mr. Allen: The Petitioner contends that factors dealing with particular accounts, collectibility thereof are relevant to establishing a bad debts reserve.

[144] The Court: I believe he testified—I believe there were three or four areas of business that he felt needed going into.

One was inventory, one was receivables, and one was payables.

I believe that was his testimony. If you want to lead him and ask him what they did about receivables, I will permit it. That should be specific enough.

By Mr. Allen:

Q. All right. Mr. Collins, taking it at the end of 1964, would you describe what, if any, reviews were conducted of the accounts receivable?

A. Yes. In 1964, as I have previously mentioned, my initial task and major responsibility was to reevaluate the assets and liabilities of the company in order to be in a position to directly report to the shareholders the status of the company, the financial status as of December 31, 1964.

And we have already covered the inventory issue, and another major asset on the balance sheet was the receivables.

At the end of 1963, the receivables were about 23 per cent of total assets. So we undertook a very careful review of the accounts receivable on [145] December 31, 1964, and the general process that was used—the technique that was used—was to evaluate individually all of the accounts that were over 90 days past due and over a hundred dollars in value.

These accounts were individually evaluated by the credit clerks who were responsible for collecting these accounts and who therefore had rather complete knowledge of the collectability or the probable collectability of each account, as these accounts that were under 100—over $100 were individually evaluated, and the portion that was assumed to be or felt to be uncollectable was determined and reserved against 100 per cent.

Then that percentage was applied to those accounts that were 90 days past due that had individually a value under $100.

Now, with accounts that were more current, we applied a—for the current accounts and those that were less than 29 days past due, we assigned a one per cent reserve. For all other accounts except the ones that we called "hard core" accounts, we reserved two per cent value.

Inter-company accounts, there was no reserve. Now, I have been speaking about the Thor Tool Division.

The Cincinnati Rubber, I believe there were only two questionable accounts that were reserved [146] against—the balance of the accounts receivable—we established a reserve of one per cent.

The experience of Cincinnati Rubber has been good.

Q. You indicated that the people reviewing these accounts had familiarity with them.

Could you describe how they acquired this familiarity?

A. Well, in our system, the individual—the accounts were segregated generally alphabetical, and the credit clerk had responsibility for the group of accounts.

It was their responsibility to not only keep track of the status of the accounts and also to approve credit for shipment against these accounts, but also to try to collect these accounts following the usual standard approaches of first telephone calls or letters and ultimately getting to the point, if they could not collect the account, by referring to it to their supervisor.

Then, their judgment that was applied individually to these accounts was reviewed by their superior who was a credit manager, and then his judgment was reviewed by the Treasurer, and ultimately the overall review of the total accounts receivable and the [147] proposed adjustments and reserves was reviewed by myself.

Q. Mr. Collins, can you tell me what, if any disallowance for tax purposes there was on the bad debt reserve taken for 1964?

A. I don't think there was any disallowance.

Q. Turning, now, to 1965, which is the year in issue, I will show you Petitioner's Exhibit 18, which has already been introduced in evidence.

Had you had a chance to review this?

A. Yes.

Q. Are the figures reflected here a summary of the analysis made at year-end 1965 with the various accounts?

A. They are.

Q. Can you tell me who conducted this review?

A. This review was performed by the same group of people—not individually—but as I indicated, we followed the same practice in '65 that we did in '64; that the initial review of what is called here "hard core" accounts was over $100, was conducted by the credit clerks having responsibility for those accounts.

And they would know—and hopefully know, and certainly know—more about it than anybody else [148] in the company as to the probable collectability of each account. But their judgment, as I indicated was reviewed by the Credit Manager and then by the Treasurer in turn.

Mr. Allen: Your Honor, I have no further questions.

The Court: Mr. Sherman?

Mr. Sherman: I have no further questions.

The Court: All right. Thank you. You are excused.

The Witness: Thank you.

(Witness excused.)

* * *

[149] WILSON J. BESANT, was called as a witness on behalf of the Petitioner, and, having been first duly sworn, testified as follows:

The Clerk: Be seated, please, sir.

State your name and address for the record.

The Witness: Wilson J. Besant, B-e-s-a-n-t, 1042 Westmoor, Winnetka.

Direct Examination by Mr. Berens.

Q. Mr. Besant, would you state your profession?

A. CPA.

Q. And how long have you been a CPA?

A. Since 1956.

Q. Have you been a practicing Certified Public Accountant continuously since that date?

A. Yes, I have.

Q. From that date on, have you been associated with any firm or public accountants?

A. Yes, I joined Arthur Andersen in 1953, and I have been with them since that time.

Q. Would you describe your career with Arthur Andersen since 1953?

A. I joined the audit staff of Arthur Andersen in 1953, was promoted to Manager in 1957, and admitted [150] to the partnership in 1963, and since May of this year, I have been in charge of the Manufacturing Audit Division of the Chicago office.

Q. Would you describe in some detail what that entails, being in charge of the Manufacturing Division of the Chicago office?

A. Well, this division, as the name sounds, is responsible for all of the audits of manufacturing companies that we handle out of Chicago, and this division consists of 12 partners, 27 managers, about 65 seniors, and other staff personnel that help do the auditing work.

Q. Now, as the head of this division, what are your duties in regard to audits conducted by other partners in that division?

A. Well, we consult with each other when we feel it is necessary.

Q. Do you get any familiarity with the problems of audits of clients other than under your direct audit supervision?

A. Yes, I did.

Q. What is the relationship with Arthur Andersen with the Petitioner, Thor Power Tool Company?

A. We were appointed auditors of Thor in connection with the financial statements of December 31, [151] 1970. And I was assigned as partner responsible for that work.

Q. Would you describe, generally, the relationship of an accounting firm of independent accountants such as Arthur Andersen with their clients when they have an engagement such as you have with Thor?

A. Well, when we are engaged to make an audit, we perform an examination of the company's books and its records, and eventually issue our opinion on the financial statements as of a certain date and for the year ended that date, and these statements and our opinions are sent to shareholders.

They are also sent to the Securities and Exchange Commission and other governmental agencies.

Q. Do you consider yourself an agent or employee of your clients?

A. No.

Q. In the course of such an audit, do you make adjustments on the books of the clients?

A. No. All we do is suggest that the client record an adjustment, and if the client refuses to record an adjustment, the only thing we can do is qualify our opinion in some fashion.

So your opinion is based on your general agreement with the presentation of their financial [152] statement as to its accuracy, consistency and in accordance with generally accepted accounting principles?

A. That is right. We made an examination in accordance with generally accepted auditing standards and express our opinion, as you suggested.

Q. I believe you stated that your relationship commenced with Thor for the fiscal year 1970, is that correct?

A. That is when we first were appointed auditors.

Q. When you are first appointed auditor for a new client, are your audit procedures different than the usual procedures?

A. Yes. We follow additional procedures that we call "first time through."

Q. Would you describe those in general and their purpose?

A. Well, we have to review the financial statements for the preceding year. We are interested in the accounting policies and principles that were followed in the financial statements of the preceding year, because we mention consistency in our opinion for the current year.

We also review the clients internal accounting procedures and internal control in order to [153] determine the scope of our audit. We look at the opening balance sheet for the accounts that have a carry-through aspect to them that float through into the current year's financial statement, such as property, depreciation, earned surplus, capital stock, and also inventory as well, because closing inventory of the prior year has an effect on the income statement of the current year.

Q. In your first time through audit procedures for 1970 for Thor, would you describe in general what you did in regard to the inventory accounts?

A. We looked at the prior auditor's working papers—Price, Waterhouse—and made notes as to work they performed. We also then visited the company and looked for evidence of the work that was done in the physical taking of the inventory and in the compilation of it.

We also checked to see that it was extended correctly. We also checked the accuracy of the price, and we also were making review to see that excess and obsolete inventories were adequately considered.

Q. In regard to the excess inventory you just referred to, did you engage in any specific procedure and, if so, what were they?

A. We did review the excess inventory situation, [154] and our procedure was to select items on a hindsight basis. In our 1970 audit, we selected 150 items from the 1969 inventory, and then checked the actual usage in 1970 of these items and recomputed the required reserve for excess stock, based on this actual usage.

And we followed a similar procedure in 1971 on a hindsight basis of the 1970 inventory.

Q. Do I understand correctly, then, that for the 150 items that you mentioned in 1970, you compared the provision set up by the company on their books with what actually happened in terms of sales to those items during 1970?

A. Right.

Q. How did you arrive at the selection of 150 items sample?

A. We selected some large items—I believe in 1970 it was 20 large items—and we selected eight blocks of 10 items in a block, and then 50 items at random.

Q. Were these items—are these physically large?

A. No, I said large—I am speaking in terms of dollars.

Q. Dollar value in the inventory account?

A. In the inventory reserve.

[155] Q. In the inventory reserve account?

A. Right.

Q. These eight blocks of 10 items, were these selected at random?

A. The blocks were, yes.

Q. Do you recall what percentage of the total value in the reserve accounts that these 150 items represented?

A. I believe it was about 15 per cent.

Q. This is in terms of value?

A. Yes.

Q. Do you recall what the results of your sample were for 1970?

A. The results of our sample indicated that the reserve for excess inventory was understated.

Q. Can you remember a dollar or percentage figure?

A. I believe in 19—

Mr. Sherman: Object, Your Honor. I think we are getting into quite a period of time here. I don't think we are even close to the taxable year.

The Court: I will overrule your objection. I think he can testify as to the—his opinion as to the correctness of the procedure utilized.

There has been testimony that the same [156] procedure was utilized in later years.

Mr. Berens: Would you read the question to the witness, please.

(Whereupon, the record was read.)

Mr. Berens: I better ask the question again.

By Mr. Berens:

Q. If you remember, do you recall for 1970 either a dollar or a percentage figure?

A. I recall it was about 17 per cent understated.

Q. Understated?

A. Understated.

Q. Let me clarify:

By "understatement," you mean what?

A. I mean the reserve, based on our tests, was not large enough.

Q. Do you recall the result for 1971 based on your tests?

A. I believe our tests for '71 indicated the reserve was understated by about 4 per cent, 5 per cent.

Q. I have here, marked for identification, Petitioner's Exhibit No. 19, which is entitled "Summary of Tests of Reserves for Excess Inventory by Arthur Andersen & Company."

[157] Was the data contained on this document prepared from Arthur Andersen's working papers?

A. Yes, it was.

Q. Were these prepared under your supervision?

A. Yes.

Q. I offer this document as Petitioner's Exhibit 19.

Mr. Sherman: I would object on the ground of relevancy. I really think this is highly irrelevant. The question here is the propriety of this method, per se, which is one of the questions, and certainly this can't go to that and this can't go to the questions of change of method in 1964.

We are talking about a test that was made by assuming the very point of issue in this case, that this is a legally acceptable method, and there is some computations that in 1970 or 1971 they should have had more reserve.

I just fail to see the relevance of this kind of document or even the testimony as far as that goes.

The Court: Mr. Berens, would you like to comment?

Mr. Berens: I would like to make clear that we are certainly not offering it to establish a change [158] of accounting method, which we think is properly the burden of the Respondent to present. We are offering it as a hindsight to show that this procedure, which has been consistently followed from 1964, was in this—based on that data—not only reasonable but perhaps understated the results. It was conservative in terms of the issue before the Court.

We don't know how we can prove the reasonableness of the formula if we can't show how it worked.

We are puzzled by the series of objections that Counsel has raised to several exhibits in addition to this one, where hindsight seems to be, in his opinion, both irrelevant and immaterial; and in a practical system such as this that was adopted, there was no way,—looking at it in a vacuum—of determining whether it is reasonable.

The only way I know how to prove this is to show how it worked, and as a preliminary, we have introduced this exhibit for a series of questions to the partner in charge of the audit to

express his opinion as to the reasonableness, both from the current years he has examined and by certain other data, by inference on how it was working from '64 on.

The Court: Well, Respondent has attempted to test the validity of the method used by the use of [159] hypothetical questions, so I think that—I don't see how Respondent can object to showing any actual tests using actual figures in later years to test the validity of the method.

So I will overrule the Respondent's objections.

By Mr. Berens:

Q. I refer you, Mr. Besant—

The Court: Exhibit 19 will be received in evidence.

(The document previously marked for identification as Petitioner's Exhibit No. 19 was received into evidence.)

By Mr. Berens:

Q. I refer you, Mr. Besant, to the last two lines on Exhibit 19 which refer to a number of items understated, and per cent of items understated, and ask you what this represents and what conclusions, if any, you derived from that?

A. Well, of the 150 items we tested in 1970 for excess inventory—128 of the items included in that group—the reserve was understated for those items—for 128 items.

It indicates that what is happening here is [160] that the sales forecast that is being used in the aging of this inventory is not being met.

In other words, actual sales are declining below the amount of sales that were forecasted for the year.

Q. Based on that hindsight that you have, both in terms of the dollar figures above and the number of items understated below, would you express an opinion of whether or not the provision in fiscal 1970 was reasonable?

A. We believe that the provision for 1970 was reasonable.

Q. Would you offer your opinion on that for 1971?

A. I would have the same opinion.

Q. Did Arthur Andersen issue a qualified opinion as to inventory for either 1970 or 1971 for this client?

A. No, we did not.

Q. You gave an unqualified opinion?

A. As to inventory, yes.

Q. Would you have issued such an unqualified opinion if this provision for excess had not been made for either of those years?

Mr. Sherman: I object to that as speculative.

[161] The Court: Overruled. I think he can give reasons why he would qualify or not qualify an opinion with respect to inventory. I don't think it is speculation. I think it goes to the heart of the opinion, so I will permit him to testify.

By the Witness:

A. We would have qualified our opinion had the company not made some provisions for excess inventory—a write down for excess inventory.

By Mr. Berens:

Q. In the course of your testimony concerning your first time through audit, I believe that you testified in addition to the sampling technique, that you had looked at earlier data in the various accounts, is that correct?

A. Historical data prior our year of examination?

Q. Yes.

A. Yes.

Q. Was there anything in that review that you discovered that indicated that the system for providing for excess inventory gave other than reasonable results in prior years?

A. No, we discovered nothing.

Q. I have here, marked for identification, [162] Petitioner's Exhibit 20, which is entitled "Summary of Income Statement Domestic Consolidation," which covers a period of years, 1962 through 1971.

Mr. Besant, was the data contained in this document taken from the books and records of Thor Power Tool Company?

A. Yes, it was.

Q. Was this document prepared under your supervision?

A. Yes.

Q. I would like to offer Petitioner's Exhibit 20 into evidence.

The Court: Any objection?

Mr. Sherman: No objection, Your Honor.

The Court: Exhibit 20 will be received in evidence.

(The document previously marked for identification as Petitioner's Exhibit No. 20 was received into evidence.)

By Mr. Berens:

Q. Would you describe generally what purports to be shown on this summary statement here?

A. Well, it is a summary of the results of operation for each of the years from 1962 through 1971 [163] of the domestic operations.

Q. And do I understand correctly that this data basically is the same that goes into the computation of the taxable income in the income tax returns of the Petitioner?

A. Yes.

Q. From the data contained on that exhibit, would you express any conclusions, if any, that you derived?

Mr. Sherman: I think that question is extremely broad, Your Honor.

Mr. Berens: I will withdraw the question and restate it.

By Mr. Berens:

Q. From the data on this Exhibit, and from your knowledge of the provision for excess inventory by the company, would you express any opinion you have as to the reasonableness from and including 1964, on, of this provision?

Mr. Sherman: I will object, Your Honor, in that the witness has stated that he first became associated with this company in 1970, and I don't believe he is qualified to express an opinion as to the reasonableness of something that was done prior to his association, and particularly since there were [164] numerous things done which are not part of the issue in this case and which already affect these figures.

The Court: I believe that he testified that he reviewed the workpapers involved in his client's business for years prior to the years that he worked on the account, and I think he is qualified to express an opinion on the statistics of what the workpapers reveal.

I will overrule the objection.

By the Witness:

A. Well, as the summary indicates, each year there is a decline in net sales. Beginning after 1964, 1965, and so on, there is a decline each year in the amount of the domestic sales. Commencing in 1965, the percentage of gross income declines for each year through 1970.

Also, from 1966 through 1971, the domestic operation shows a loss before income taxes when you exclude the dividends from the foreign subsidiaries in 1966 and 1971.

So that there is a downhill trend that is exhibited by this summary.

And to the question that you posed about an excessive write off for excessive inventory, this schedule, I would think—or I think—indicates [165] that the write off in '64 was not excessive because of the continued decline in the gross profit percentage through all of the years.

If the write off in '64 was not excessive, I would assume that the items that were written down too much were sold and would be reflected as gross profit at the gross income line here.

And there would be a more constant—a steady gross profit or possibly an increase, whereas in this schedule there is a steady decrease throughout all of the years.

By Mr. Berens:

Q. Mr. Besant, you said "if it were not excessive."

Did you mean to say "if it were excessive"—the provision?

A. If the '64 provision were excessive, you would expect to see, I think, a different pattern in the gross profit percentage. You would not expect to see a steady decline. If the write off was excessive, it would only be excessive if the items were being sold, and there is no indication of that pattern in this exhibit.

* * *

[168] *Cross Examination by Mr. Sherman.*

Q. Mr. Besant, I would just like you to tell me if you agree with the following statement which represents the definition of commercial accounting practices: "It has been stated that the primary function of commercial accounting is the extraction and presentation of the essence of the financial experience of businesses so that the decisions effecting the present and future may be taken in light of the past."

Would you generally agree with that statement?

A. Let me hear that last line again about the present and future and past.

(Whereupon, the record was read.)

By Mr. Sherman:

Q. I am sorry.

Did you say you would agree or disagree?

A. I can't say it is harmful.

Q. Would you generally agree with that? Is it a reasonably accurate statement?

A. I will agree.

Q. Would you also agree with the following statement: "As opposed to this rather broad function [169] for commercial accounting, the purpose of tax accounting is limited to providing an income figure on which to compute tax."

Mr. Berens: Objection, Your Honor; this witness has not been established as an expert in tax accounting, and I believe it is also beyond the scope of direct examination.

Mr. Sherman: Might I ask the witness one question which would perhaps clarify this, and if it does not, I will withdraw the question.

Can I pass this question for a moment?

The Court: Very well. Ask the question and see.

By Mr. Sherman:

Q. Mr. Besant, have you testified, then, in terms of normally accepted commercial accounting practices?

A. I have testified in accordance with generally accepted accounting principles.

Q. Is it generally accepted accounting principles for businessmen or business organizations to set up many different types of reserves on their books and records in addition to a bad debt reserve, other than bad debt reserves?

A. Yes, it is a general practice.

[170] Q. Is it sound accounting practice to treat as an expense the cost of issuing a stock dividend?

A. The cost of issuing a stock dividend?

Q. Yes. The taxes and mailing costs and all of the costs incurred in the issuing of a stock dividend.

Would that be considered an expense within the framework of generally accepted accounting practices?

A. I think you see it handled in one of two ways, because of materiality. Typically, in some instances, it is charged to capital surplus of the capital stock account, and in some cases it is charged to operations.

Generally, the amounts involved are not very significant.

Q. But such expenses, then, is consistent with sound accounting principles and charged as current expenses?

A. In the materiality phrase, right.

Q. What does that refer to, the "materiality phrase"?

A. Well, we have our generally accepted accounting principles and the variances from those principles are judged by the CPA in the light of materiality. There is no black and white

definition I can give you [171] as to what percentage of net sales or net income is material.

It depends on all of the particular facts and in the particular case.

Q. Let's assume that an automobile dealer is discounting his commercial paper with a bank with recourse—

Mr. Berens: Your Honor, unless Counsel can make it more clear how that relates to the direct examination of the witness, I would have to object again.

Mr. Sherman: I have not finished the question.

The Court: Why don't you finish the question?

Mr. Sherman: This is a hypothetical, Your Honor, and I think at the close of the question we will really know whether it is objectionable or not.

By Mr. Sherman:

Q. Let's assume an automobile dealer discounts commercial paper with a bank with recourse. The bank establishes a reserve out of the amounts otherwise due the dealer, which the dealer cannot receive.

This reserve would be used to take care of the dealer's responsibility in defaults and possessions [172] and so forth.

Would it be consistent with sound accounting principles for the dealer not to consider the amount of this reserve as part of his income?

Mr. Berens: I would like to renew my slightly premature objection.

The Court: On what grounds?

Mr. Berens: On the grounds it is beyond the scope of direct examination and probably is irrelevant, though I can't tell yet.

The Court: I will overrule the objection. I think he is testing the witness—as I can see it—on what generally accepted accounting principles are, and I think he is entitled to do that.

By the Witness:

A. I am not sure I followed all of that. The bank has a reserve?

By Mr. Sherman:

Q. Right. It is a dealer reserve situation, and I assume you have come across that before?

A. I have not handled any automobile dealers, just manufacturing companies.

The bank has a reserve that holds back and does not lend the full amount to the automobile dealer?

[173] Q. Does not pay him the full amount of the price of the commercial paper as discounted by the bank, and this part is kept in a reserve which will be held against any sort of default or any sort of liabilities which the dealer may ultimately be subject to because of his remaining obligations under the paper to discount.

Now, strictly from an accounting standpoint, should this reserve be considered currently income to the dealer?

A. I don't see how it is income if it is—it all becomes involved, I would think, in the overall evaluation of the receivables.

Q. And it is not currently income in terms of generally accepted accounting principles?

Would that be your answer?

A. I believe so.

Mr. Sherman: I have no further questions, Your Honor.

Mr. Berens: I have no further questions on redirect, Your Honor.

The Court: Very well. You may be excused, Mr. Besant.

* * *

[23 June 1972]

[177] ROBERT M. TRUEBLOOD, was called as a witness on behalf of the petitioner, and, having been first duly sworn, testified as follows:

The Clerk: Be seated please and state your name and address for the record.

The Witness: My name is Robert M. Trueblood, 190 Thackery Lane, Northfield, Illinois.

Direct Examination by Mr. Abrams.

Q. What is your occupation, Mr. Trueblood?

[178] A. I am a CPA in public practice.

Q. How long have you been an accountant?

A. I have been in accounting since 1937.

Q. What is your present position?

A. My present position is Chairman of the Board of Directors of Touche Ross & Company.

Q. And that is a public accounting firm?

A. That is a public accounting firm, national and international.

Q. How many accountants are employed by that firm?

A. In the United States, I would say about 4,000.

Q. You have been Chairman since when?

A. I have been Chairman for—Chairman of the Board for 9 or 10 years.

Q. What offices have you held in the American Institute of Certified Public Accountants?

A. In the American Institute, I have been a vice president, a member of council, which is our legislative body, and I was president of the American Institute of CPAs in the years '65, '66.

Q. Which of the major committees and Board of Directors of the AICPA have you been a member of?

A. I was Chairman of the Long Range Objectives [179] Committee of the American Institute, whose purpose was to plan and plot the future of the profession, as it were. I was a member of the APB, the Accounting Principles Board, for a couple of years. I was Chairman of the International Study Group of the Institute, which included representation from about 6 countries to examine into standards of practice of the various countries in an effort towards coordination. I am presently Chairman of the Commission on the Objectives of Accounting, the purpose of which is to formulate, if we can, the broad purposes and objectives of the accounting process and the resulting financial statements.

Q. What was the function—what is the function of the Accounting Principles Board?

A. The Accounting Principles Board was and is that body of the Institute whose responsibility it is to determine the applicable standards and principles for the practice of accounting by the profession in the United States.

Q. In your practice of accounting, have you devoted substantial time to accounting for manufacturing companies?

A. Yes, I have. A large part of our practice is in the manufacturing area.

[180] Q. And your personal experience has been in that area also?

A. I have had personal experience in the area in the sense of being in the field as a junior accountant and running on up through management of jobs in the manufacturing area.

Presently in my role as Chairman of the Board I do not have client responsibility, but those particular problems of difficulty or complexity come to me for discussion, decision, resolution and naturally enough, considering our practice, that includes a large number of manufacturing problems.

Q. In preparing financial statements for a manufacturing company, what goals do you seek to achieve in valuing assets?

A. In valuing assets, the goal given a going concern assumption which overlays or underlies all financial statements, our purpose is to state assets in such a way that there is a reasonable expectation of the realizability of the valuations included in those assets.

Q. What goals do you seek to accomplish in income-statement accounting?

A. In income-statement accounting we attempt to match revenues and costs, all of which have a [181] relationship to the asset valuations we spoke about previously, in such a way that the net income for the period involved is truly reflective of the economic or financial gain or loss for that period, which means that we must consider in effect separately those items of income which are properly realized and therefore reportable in the period involved.

Similarly, we must search out for those costs which properly relate to the realization of the revenues which have been reported, the residual being the net income or loss as the case may be.

Q. How are those principles applied to accounting for inventories in the case of a manufacturing company?

A. In the case of a manufacturing company, typically inventory is the most important asset, maybe not the largest, but the most important asset. And in terms of income determination, the beginning and ending inventories are similarly one of the most important ingredients of the income determination.

Q. In particular, what significance does the inventory valuation have with respect to the income statement?

A. Well, income statement starts out with sales. One must determine the cost of goods sold which relates [182] to those sales. The beginning and ending inventory are significant factors in the determination of the cost of sales.

Q. If the closing inventory is overstated in a particular year, what effect does that have on the net income?

A. If the closing inventory in a particular year is overstated, then income is overstated.

Q. And conversely?

A. And conversely.

Q. In accounting for inventories for a manufacturing company on the basis of a lower of cost or market, what procedures are followed generally?

A. Well, in determining lower of cost or market—did you say what procedures are followed?

Q. Generally.

A. The underlying rules and regulations come out of the literature of the Accounting Principles Board and its predecessor the Accounting Procedures Committee. The controlling regulations which all of us must follow were originally stated, I think, in Opinion No. 6, then codified in No. 43 and are still, in effect, without significant or substantial change.

In looking at cost or market, the cost is, I might say, given, it is not always that easily [183] determinable, but the rule requires if cost is not going to be recovered, then there must be a restatement or a devaluation, as it were, of the inventory to what might simply be called the net realizable value. The technical rules are a little more complicated than that, but the purpose we are trying to achieve is to get that inventory down, as I stated, in times of asset formulation to a reasonably realizable net value in the normal course of business.

Q. A net realizable value will be equated with market for these firms?

A. That is fair enough.

Q. You referred, Mr. Trueblood, to the rules and regulations which the profession has, and particularly to what you described as No. 43. Would you clarify that for us, please?

A. Well, going way back to the 30's, we had what I think was called the Accounting Procedures Committee. The bible, as it were, on inventory evaluation was Bulletin No. 6. Then in the course of the development of these rules and regulations, all then [extant] and still continuing bulletins were combined into what was called Accounting Research Bulletin No. 43. It was sort

of a codification of pre-existing rules and regulations, and it is still in effect and [184] has been adopted by the now Accounting Principles Board as the official statement of the Institute on inventory matters. Forty-three includes a lot of things, but it includes explicitly this matter of inventory.

Q. And the provisions in 43 with respect to inventory are mandatory within the profession?

A. By resolution of council of the American Institute, which is our legislative body, all members of the American Institute must comply with the rules or literature of the Accounting Principles Board. If they depart, they must disclose their departure. And further than that, in such departure they must indicate that they have relied upon substantial authoritative support and defend any departure in those terms.

So, as a practical matter—In fact, I know of no single case in which a report has come out in which it is said that we have departed from these rules in reliance of other substantial authorities for support. So, as a practical matter, an annual report, company by company, the rules of the Accounting Principles Board apply across the board and include the S. E. C.

Q. Is it fair to equate Bulletin 43 with generally accepted accounting principles that are used in [185] accounting opinions?

A. Certainly.

Q. What do those principles provide in accounting in terms of excess inventory?

A. Referring specifically to, I believe it to be Chapter 4, the statement is made that if there is any indication of loss of utility in inventory, that an appropriate downward valuation must be made of that inventory in order to accomplish the statement of inventory at a reasonable net realizable value. A loss of utility could include a number of many things. It could be damage to the product, obsolescence, loss of market in the sense that products on hand are greater than a reasonable forward expectation of sales, and all those kinds of things.

That is, if you had a product which costs you a dollar, you typically sell it at a dollar and a quarter and in the economic

sense there is a loss of utility in the sense that you could not reasonably expect to sell it for a dollar and a quarter in the future. Then you have to reduce to the lower of cost or market in order to accomplish a reasonable valuation of inventory.

Q. Now, dealing specifically with the question of excess inventory, that is, inventory that can be [186] sold for a dollar and a quarter in your example, but there is more of it than is reasonably expected to be sold. What is the requirement of the Bulletin 43?

A. Excess inventory—an excess in inventory would be interpreted to be a loss of utility, which would require a downward adjustment under the principles of 43.

Q. Are there any exceptions to the rule?

A. There is a technical, technical ceiling and floor in this write down process, if you care to get into that.

Q. In terms of the level to which you write it down.

A. In terms of the level to which you write it down, there is a ceiling and a floor explicitly stated in Chapter 4, and I can explain that to you if you like.

Q. What is the highest level which you can show that inventory?

A. The highest level that you—

Mr. Sherman: Your Honor, I will object. I believe that Bulletin 43, if the witness is to rely on it, should be in evidence, should be before the Court. It would certainly appear to speak for itself, so that the parties and the Court may determine to what [187] extent the bulletin is being accurately described by this witness.

The Court: Do you have any objection to introducing it into evidence?

Mr. Abrams: No, Your Honor, I don't. I would like to have this witness testify on a much broader basis than just on Bulletin 43. He has indicated that Bulletin 43 is essentially the bible on inventory valuation. I certainly have no objection to offering Bulletin 43 in evidence. I hadn't thought of doing it that way,

since it seems to be a publication, any more than I would offer a [torts] Treatise in evidence perhaps in a personal injury case.

If Mr. Sherman wants me to mark a copy of Bulletin 43 as an exhibit and offer it as such, I will be happy to do so.

The Court: Why don't you offer it in evidence.

Mr. Abrams: I have only excerpts, two chapters here. I take it, Mr. Sherman, you don't want me to mark and offer the entire—I don't know, it's a couple of hundred pages, isn't it?

The Witness: Yes.

Mr. Sherman: I have never seen this.

Mr. Abrams: You have never seen this [188] Bulletin 43? For a moment, Mr. Sherman, I hand you my copies of Chapters 4 and 6 dealing with inventory pricing and contingency reserves. I would be happy to have copies made over the recess and have those two chapters introduced in evidence as—what is our next number?

Mr. Berens: 28.

Mr. Abrams: —as Petitioner's Exhibit 28.

The Court: What chapters are those you referred to?

Mr. Abrams: Chapter 4, dealing with inventory pricing, and Chapter 6, dealing with contingency reserves.

By Mr. Abrams:

Q. Mr. Trueblood, is there an opening section of Bulletin 43 which describes its general purposes?

A. I can't answer that explicitly. It was a codification. I would presume there is a preface as to how it was done, what was deleted and what was included. I cannot answer that specifically, I would refer you to APB Decision No. 6, which incorporates 43 as pre-existing and presently operative literature.

Mr. Abrams: Your Honor, if I may expand the exhibit to include whatever introductory material there is in Bulletin 43 to describe the manner in which [189] it is organized and the purposes which it is to achieve. We are attempting to bring a copy of the whole thing over so Mr. Sherman can look at it and

expand the exhibit any further. We could include any other portion which he wants.

The Court: Very well. I will anticipate you will offer Exhibit 28, certain portions of Bulletin 43, including Chapters 4 and 6 and whatever other chapters to explain the background. Is that correct?

Mr. Abrams: Yes, Your Honor.

The Court: Very well. I will permit the witness to testify with that understanding.

By Mr. Abrams:

Q. Dealing with generally accepted accounting principles, Mr. Trueblood, with respect to excess inventory, there is a ceiling, you said, there is the highest level at which excess inventory can be shown on the balance sheet.

A. The ceiling and the floor relate to the determination of market in general, and generally market as it is used in the phrase "lower of cost or market" refers to replacement cost, whether by purchase or by production, reproduction. The ceiling, as stated in these terms, says that market shall not exceed the net realizable value less reasonable costs to dispose. [190] The floor says that you shall do the same thing except that you may not get it so low that one would realize more than a normal profit margin on the ultimate sale.

Q. Subject to those floor and ceilings you have described, is there an exception to the rule that you have to write down excess inventory?

A. No. It is not an exception, it is a general interpretation of the concept of market. We say that market means replacement value. Then in determining replacement value we have to consider the utility or disutility of the particular inventory item [illegible] what I said or intended to say was that whenever there is a [illegible] of utility of an inventory item, as in the case of excess parts, obsolete parts, damaged parts, then we must go into this lower of cost or market routine.

Q. And if your firm is auditing the financial statement of a company which has excess inventory which that company refuses to write down below its cost, what action would your firm take?

A. If it were a material item, we could not give them a clean opinion.

Q. By a "clean opinion," you mean, Mr. Trueblood, what?

A. An opinion without exception. In our opinion we believe these statements fairly present and so on.

[191] I might go back a little bit, Mr. Abrams, and say as a part of any audit, this is not gratuitous, we would require a determination by a client to our satisfaction that there was not a circumstance of existing excess parts, or if we were, then we would require some kind of write down in order to give a standard opinion.

Q. By standard opinion or clean opinion, you mean one without qualification?

A. One without qualification.

Q. Under generally accepted accounting principles, is it necessary to wait until an item is actually scrapped to write it down as excess?

A. No, in terms of generally accepted accounting principles it is not necessary to wait until it is scrapped. In fact, there are many circumstances in which it is undesirable to precipitate that scrapping. Excess inventory is a case in point in that let us say we are talking about an industry where service is important. Like in household appliances, if something goes wrong you want to call the jobber or the distributor and be able to get a part to make that refrigerator work that morning. Automobiles is another situation where that similar circumstance exists.

So, the manufacturer of the basic product [192] and therefore the manufacturer in most cases of the replacement item is in a difficult management and economic situation in his attempt to determine what, if any parts he should carry over in the event of possible call or need. So, even though one might know or suspect or predict that you have excess in terms of gadget "x", a

good manager is frequently indisposed to scrap it indiscriminately less there be an unanticipated need. So, there is generally a delay in these after-market situations in physical scrapping or disposition.

Q. From the point of view of accounting theory, is there any difference in substance between a write down to market or a write off of items that are unsaleable?

A. You mean write off in the sense of just taking it off the books completely?

Q. Yes.

A. Or write down in the sense of setting up a reserve?

Q. Setting up a reserve, that is not the distinction—

A. Write off and write down are really synonymous.

Q. Whether you put them in a reserve or actually [193] take them off the books?

A. Whether you take it off the books or put them in a reserve is really not germane to the issues, or not relevant to the issues. You are accomplishing the same thing. If you then offset the reserve against the reserve and balance sheet, you get the net realized value for reserve purposes.

As a matter of fact, in many instances, for purpose of managerial control and administrative ease, we would recommend the reserve technique as distinguished from direct write off or write down, but this is a matter of mechanical and administrative simplicity rather, there is no principle involved in that.

Q. If you are on the lower of cost or market, you are obligated to write it down to a market level?

A. You are obligated to reduce the value to a market value by whatever technical means.

Q. Is there any distinction theoretically between the write down to a market level and the general concept of cost or market and the write down or write off for obsolete or excess unsaleable items even if you are not on a lower of cost or market?

A. You have to restate that question, Mr. Abrams, or state it again. I'm sorry.

[194] Mr. Abrams: Would you read it back, please.

(Whereupon the record was read.)

By the Witness:

A. Well, for accounting purposes, cost is not an acceptable method. For accounting purposes we must always be at the lower of cost or market. That is a principle without exception including really FIFO, although that gets into a pretty technical method.

In all cases that you mentioned, excess, obsolete or damage, was that the other one, we are talking about recognizing the loss of utility of an inventory initially valued at cost in order to get it down to a valuation which represents net realizable value in the economic sense, economic and financial sense.

By Mr. Abrams:

Q. Is it in accordance with generally accepted accounting principles to determine the amount of an inventory write down for excess by the use of a formula based on anticipated usage? Excuse me, rather than doing it on the basis of an item by item market analysis.

A. It is a very frequent practice in my experience. In the first place, estimates of forward usage [195] are the appropriate means of determining, forward or past usage are the appropriate means of determining whether one has excess stock or whether one does not have excess stock, but as a practical matter and in a multiplicity of items it is almost requisite administratively and in the internal accounting process to use some formula which hopefully achieves a reasonable approximation of what you are at. If a company has fifty or one hundred or two hundred thousand or even more individual items making this kind of calculation on a nut and bolt basis, it just wouldn't get done.

Q. Is it also in accordance with generally accepted accounting principles to compute this formula on the basis of prior usage?

A. Prior usage or forward usage, as I indicated. In terms of history, we probably relied more on past usage than estimates of forward usage. I would say that in certain industries and in certain situations given the computer we are now able to take more advantage of mathematical means of extrapolation with respect to forward usage, expectations of forward usage, I'm sorry.

Q. By "forward usage," you mean predicted usage?

A. Predicted usage for future periods.

[196] Q. So you really just refined the basis for making predictions?

A. That is right.

Q. Prior to your testimony today, have you reviewed the statutory notice of deficiency that was directed to the taxpayer?

A. I did.

Q. And the petition filed by the taxpayer in this Court?

A. I did.

Q. You also reviewed the Answer and the Amended Answer filed by the respondent?

A. I did.

Q. And the reply to the Amended Answer filed by the taxpayer?

A. Yes, sir.

Q. Have you also reviewed the Stipulation of Facts?

A. Yes, sir.

Q. Have you also reviewed the Exhibits 13 through 17 and 19 through 27?

A. Not so fast on that. 13—

Q. 13 you have before you.

A. I have before me. 18, 19, and 20 I have before me.

[197] Q. Let me show you the other exhibits to which I am referring.

A. 22, I have before me.

Q. 14 through 16, and 24 through 27—I'm sorry, 23 through 27 are the spread sheets entitled "Summary of Inventories and Valuation Reserves for the years '64 through '71."

A. For the years '64 through '71.

Q. Have you also reviewed those?

A. I have seen these, I have seen these, yes.

Q. I didn't bring 14 through 16 with me, but they are the same type of documents.

A. Yes, I have seen these for the years '64 through '71.

Q. And Exhibit 17, I believe, shows the dispositions by year of inventory items by Thor. Have you seen that tabulation also?

A. Dispositions by year? I have dispositions by year on 22. I do not recall a separate exhibit.

Q. It was one of the exhibits attached to the stipulation, the last one attached—

A. There are no exhibits on my stipulation, if this is critical.

Q. It is called "Analysis of Dispositions at Aurora and Los Angeles."

[198] A. I guess I have had it, but I haven't studied it.

Q. On the basis of the materials that you have studied, Mr. Trueblood, in your experience—oh, I'm sorry. Have you also reviewed Exhibits 19, 20 and 22 which you have before you?

A. Yes, 19, 20 and 22 I have before me and I have reviewed.

Q. On the basis of the materials that you reviewed and your experience, have you an opinion as to whether Thor was under generally accepted accounting principles obligated to write down its excess inventory in 1964?

A. I would say yes, and I would refer back to the big long exhibit you gave me which analyzed their reserve calculations. The indications of stock in excess of reasonably anticipated usage indicate that some such step had to be taken.

I would also comment in relation to Exhibit 20, looking at the 10 year history of the domestic operations of Thor with sales having reduced by more than 50 per cent in a 10 year span, I

would just intuitively expect that there would be some inventory gyrations or excesses in terms of level of stock or discontinued items or excess items in terms of forward [199] requirements given the significant downward trend in sales. This would be a natural phenomenon in any business.

Q. Have you an opinion as to whether it was in accordance with generally accepted accounting principles for Thor to accomplish its computation of excess through the use of a formula based on prior usage?

A. I think that is quite appropriate, quite common and generally used in my experience in similar industries or circumstances.

Q. Directing your attention, Mr. Trueblood, particularly to Paragraph 8(b) of the Stipulation describing the number of inventory items which Thor had in 1964. What effect does that factor have on your opinion as to the extent to which Thor's use of a formula was in accordance with generally accepted accounting principles?

A. The very fact that there was some 44,000 items in inventory, including 33,000 incidentally of finished parts, would indicate that resort to a formula approach would be requisite in order to get the job done.

Q. And turning to the specific formula which Thor used, as described in Paragraph 9 of the [200] stipulation, that is, Paragraph 9(c).

A. 9(c)?

Q. Yes, page 6 of the Stipulation of Facts.

A. Yes, sir?

Q. Does that formula appear to be consistent with generally accepted accounting principles in that it accords no value to inventory items in excess of two years anticipated usage?

A. The formula described in 9(c) seems to be a reasonable approach to accomplishing the required result of writing down inventories to net realizable value. The test of the approach, of course,—the test of the specific provisions, mathematical provi-

sions of the formula is determined by the result it achieves, but it looks like a reasonable procedure in order to accomplish the principle required.

Q. Directing your attention to Petitioner's Exhibit 19, the summary of tests performed by Arthur Andersen & Company.

A. Yes, sir?

Q. Have you an opinion based on this exhibit as to the reasonableness of the formula used by Thor to compute its excess inventory?

A. The Exhibit 19 indicates that on a rather substantial sampling basis, Arthur Andersen determined [201] that in '70 and '71 the formula produced results which still represented an understatement of the inventory in terms of actual experience.

It is my understanding that the formula in the '70 column relates really to '69, and then the '70 column relates actual experience of '70 to the results of the formula at the end of '69, and the Arthur Andersen tests indicate that even so, the formula had not taken a large enough write down.

Q. So then it was the reserve that was understated rather than the inventory itself?

A. The reserve would be understated if this be correct, the reserve would be understated and the inventory would be nonetheless overstated.

Q. Assuming that the formula described in Paragraph 9(c) was used by Thor, Paragraph 9(c) of the Stipulation of Facts, the formula which we have just referred, assuming that formula was used consistently by Thor in each of the years after 1964, including the years for which Arthur Andersen made the test described in Exhibit 19, have you an opinion as to the reasonableness of that formula over that period?

A. Well, I do have an opinion. This is Exhibit 22?

Q. No, referring only to—

[202] A. Only to 19 still?

Q. 19, considered on the assumption that Thor used through all of the intervening years the same formula.

A. If '70 and '71 are representative of the situation in the prior years, then it is a very reasonable formula, and it seems to have been a reasonable formula and yielded the desirable results even so with some understatement.

Q. By "desirable results," Mr. Trueblood, you mean results in accordance with generally accepted accounting principles?

A. That's right, the reduction of inventory to a net realizable value.

Q. Directing your attention now, Mr. Trueblood, to Petitioner's Exhibit 22.

A. Yes, sir?

Q. Have you an opinion as to the reasonableness of the Thor reserve for excess in computations of credit to that reserve on the basis of this exhibit?

A. I'll take the answer to that question in two pieces. First may I look at the ending reserve of two million one eighty-one, which has been established on the basis of the formula. We just talked about Exhibit 19, where Arthur Andersen for '70 and '71 [203] established that the valuation was reasonable. Projecting or extrapolating that conclusion to similar circumstances at the end of '71, that would be a reasonable result.

I have also made some rough calculations based on the data in Exhibit 22, which indicates that the average provision of excess and obsolete for the 8 years beginning '64 was $755,000 per year. The average dispositions for the 8 years, beginning '64, were 501,000. So, you have a provision of 755,000, 750,000 to compare with actual recorded dispositions of 500,000, and although there is a disparity there, one still has to provide for the presently required two million one eighty-one reserve, because you still presumably got excess parts in that inventory. So, the relationship seems reasonable.

Taking those same figures for 7 years, starting 1965, your average provision is only 350,000, whereas your average dispositions go to 575,000. So, on the 7 year span it was too little.

And may I make one other comment? Typically in a manufacturing situation, dispositions, the recording of dispositions is

difficult because of your junk or your scrap or what have you, and you cannot possibly identify that scrappage with what went into [204] the formula or what went into the reserve. So, typically in a manufacturing situation, recorded dispositions are understated and some of the dispositions which happened in fact tend to get [buried] in the inventory shortage simply because they—you have to have paperwork to record a disposition, and if that paperwork doesn't really work, then your dispositions are apt or will be on the low side.

The Court: Let me interrupt here. That is because the disposition is a physical thing, is that not correct?

The Witness: Yes.

The Court: And a determination of excess inventory is a technique of valuation as distinguished to physical action on the inventory?

The Witness: Right, Your Honor. My point is that you can't get the physical action of disposition recorded unless appropriate paperwork is generated to do the recording, and the way you work—

The Court: Well, these two things really work independently?

The Witness: They work independently of each other, yes, sir.

The Court: I see.

[205] By Mr. Abrams:

Q. Is it appropriate to consider the dispositions in a particular year against the credits to the reserve in the immediately preceding year or should there be a lag?

A. There should be some kind of a lag, because so long as you stock an item you have to make this market determination which gets it down to a reasonable value. So, unless you say that everything I stock at December 31, '72 is going to be or has to be sold in the year '73, you have to look further.

Maybe automobiles is the best example of that. Model year '72 is going to be on the roads very actively for three or four or five years, and it's really going to be on the roads for longer than that, and so long as that automobile is on the road, somebody somewhere has to have replacement or spare parts to take care of the customers. So, you have to look at the inventory over time and the dispositions over time. So, a year by year is not appropriate where the economic utility of the initial product has more than a one year life.

Q. I believe you previously testified, Mr. Trueblood, that the formula adopted by Thor in 1964, utilized by Thor in 1964 for computing its excess [206] inventory was theoretically reasonable in accordance with generally accepted accounting principles on a foresight basis. On the basis of these other exhibits about which you have testified, have you an opinion on a hindsight basis?

A. A hindsight basis looks pretty good to me. I would correct you, if I may, or if it's necessary for the record, that what I said was the formula approach was a reasonable procedure used to accomplish a required principle.

Q. Didn't you also testify, Mr. Trueblood, that the formula, the particular formula insofar as it had a complete write off of items in excess of two years anticipated usage appeared to be reasonably consistent?

A. It appeared to be reasonable or non-reasonable. We must remember in the entire accounting process we are talking about approximations, we are not talking about fine determinations.

Q. Now, Mr. Trueblood, directing your attention to Petitioner's Exhibit 13, entitled "Special Reserve for Excess Inventory Valuation."

A. Yes, sir?

Q. And also Paragraph 10 of the stipulation which states, if I may summarize it, that the credits to the reserve for excess depicted in Exhibit 13 were [207] computed not on the basis of the formula, but on the basis of estimates applied to items as to which the formula could not be applied on the same basis.

Have you an opinion as to the reasonableness and the propriety in accordance with generally accepted accounting prin-

ciples of writing down excess inventory in this fashion even though a formula is also being applied to other parts of the inventory?

A. A formula requires knowledge about usage. The principle about obsolete over stock or what have you applies to all inventory. So, if the items indicated on your Exhibit 13 could not be fitted into the formula because of lack of data, it is completely appropriate to consider them separately. In fact, it would be completely possible or appropriate to take the total inventory and use one formula on a part of it and another formula on part of it, or two different approaches to it. I don't care what procedure you use in order to accomplish the desired principle.

Q. Would it be in accordance with generally accepted accounting principles to describe Thor's manner of accounting for its inventory at the end of 1964 as lower of cost or market?

A. Yes, there's no question in my mind that lower of cost or market would be a proper designation, [208] description.

Q. If your firm had been the auditors for Thor at the end of 1964 and Thor had refused to write down its excess inventory, what action would your firm have taken?

A. As I said before, in all inventory audits we required a determination of the existence or non-existence of excess stock. If there is such excess stock, we require a downward valuation of it, and therefore if Thor had—if these facts are as they are stated in all of these exhibits, if Thor had not taken this action and had we been the auditors, we would have had to give a qualified opinion.

Q. Qualified with respect to the inventories?

A. Qualified with respect to the inventories.

Q. Do generally accepted accounting principles prohibit the use of arbitrary inventory reserves?

A. Yes, that is covered by Chapter 8 in—no. Chapter 6, I think, of 43.

Q. What kind of inventory reserves are prohibited by generally accepted accounting principles?

A. Let's generally categorize them as contingency reserves, very broadly speaking. Some examples might be, let's say you were persuaded that the economy was going to go down and the price level was going to [209] go down and you made an inventory provision for the fact that the price level was going to go down. That would be an inappropriate accounting reserve for inventories or for anything, for that matter.

Let us say that you established some kind of reserve with respect to inventory contemplated to be purchased but not yet purchased. That would be another kind of non-permitted inventory reserve.

Let us say you establish a devaluation reserve to protect yourself against the possibility that you might discontinue some product lines. That would be an inappropriate inventory reserve.

Q. Would you characterize the reserve that Thor applied against its inventory for excess as similar to the type of reserve you have just described?

A. Not in my understanding, no, sir.

Q. How does it differ from that type?

A. As the Thor inventory reserve was dealing with explicit products on hand, products in the sales market or at least available for sale were dealing with a history of past usage from which they in effect extrapolated the possibility of future sale. So, in no way does that formula—in no way is that formula analogous to the general contingency type reserves that I was attempting to explain by example.

[210] Q. Do generally accepted accounting principles and terminology distinguish between on the one hand a change in accounting principles and on the other hand a change in accounting procedure?

A. Yes, they do. The principle is the broad overriding criterion or criteria. The procedures are the mechanics by which you accomplish those principles. What we have been talking about, the valuation of the inventory at the lower of cost or market, is the principle. The formula, the detail, the mechanics by which you achieve that valuation is the procedure.

Q. Let me ask you some examples, Mr. Trueblood. Would you describe a change from the cash receipts and disbursements basis to the accrual basis as a change in principle or a change in procedure?

A. A change from cash to accrual is a change in principle.

Q. Or vice versa?

A. Or vice versa.

Q. A change from LIFO to FIFO inventory or vice versa, is that a change in principle or procedure?

A. That is a change in principle.

Q. Or in accounting for long term contracts, a change from the percentage of completion basis to the [211] completed contract basis or vice versa?

A. That is a change in principle. A change from completion to completed contract or the other way around is a change in principle.

Q. Or a change in accelerated depreciation to straight line depreciation or vice versa?

A. Or vice versa on depreciation, a change from accelerated to straight line would be a change in principle.

Q. How about a change from computing depreciation on the basis of lives of individual items to computing it on the basis of lives of groups of items?

A. Changing from individual items to groups of items or the other way around would be a change in procedure.

Q. How about a change in computing the bad debt reserve from an age of account basis to a percentage of sales basis, is that a change in principle or a change in procedure?

A. A change in procedure.

Q. A change in computing inventory quantities by complete count to computing them through use of sampling techniques, a change in principle or procedure?

A. Going from total count to sampling or [212] statistical approaches would be a change in procedure.

Q. A change from allocating overhead on the basis of labor dollars to allocating it on the basis of machine hours, is that a change in principle or procedure?

A. Labor hours to machine hours?

Q. Yes.

A. That is a change in procedure.

Q. Now, assuming that the only method, the only procedure that Thor used in 1964—I'm sorry, 1963, with respect to its inventory was valuation for excess, the procedure described in Paragraph 6 of the Stipulation.

A. That is 6(a) at the top of the page?

Q. Yes. Assuming that Thor computed a credit on its reserve for excess inventory on that basis and that basis alone in 1963, and that in 1964 Thor computed the credit to its reserve for excess inventory in the manner described in Paragraph 9 and 10 of the stipulation.

A. For simplification, that is changing from the 10 year amortization basis to the 10 year procedure?

Q. Yes.

A. That is a change of procedure, each of which [213] should have accomplished the procedure of lower of cost or market.

Q. But it would not, in your opinion, be a change in accounting principles?

A. It would not.

Mr. Sherman: I will object. The effort is obviously being made here to have the case decided by the witness but not by the Court.

The Court: I didn't hear you.

Mr. Sherman: I said I believe an effort is being made here to have this witness decide this case rather than have the case decided by the Court. The issue as to whether there has been a change in accounting pattern is to be an issue to be decided by the Court.

The Court: I don't agree. I think this witness is testifying strictly from an accounting standpoint.

Mr. Sherman: Oh, I agree, Your Honor, from that standpoint, but I don't believe it is relevant.

The Court: I think whether generally accepted accounting principles are applied to achieve a tax result is still another question. I don't think this witness is in any way invading the province of the Court to decide whether a principle or a procedure or [214] method or whatever tag you put on it is under general accounting principles the same under tax accounting principles.

I have listened to his testimony very carefully and I believe that he is testifying from an accounting standpoint.

Mr. Abrams: Your Honor, may I add to that? Under normal circumstances I would keep quiet, it looks like you are about to overrule an objection, but if I can be a little clearer on what Mr. Sherman's objection was. The legal issue is whether there has been a change in accounting method. I have not asked this witness to express an opinion as to that legal conclusion. I have asked him only as to what the accounting profession distinguishes between changes in principle on the one hand and changes in procedure on the other. We will then argue, of course, as a matter of law that what the accounting profession describes as a change in principle is identical with that which the law describes as a change in accounting method. Obviously that is a matter for brief and not for the witness' concern.

Mr. Sherman: With that understanding, as long as that has been made clear as to the nature of this testimony, I will withdraw my objection.

[215] The Court: Very well.

Mr. Sherman: As long as the record is made clear.

The Court: That is the way I understood the statute. He has testified with respect to distinguishing features between an accounting principle and an accounting procedure. Now, whether he crosses the bridge from one of those to an accounting method

I think is the legal question involved probably, and therefore that, I think, is the way I understand the area of his testimony.

By Mr. Abrams:

Q. So that the record will be clear, Mr. Trueblood, what is your opinion as to distinction between the manner of computation described in Paragraph 6 on the one hand and that described in Paragraph 9 and 10 of the Stipulation on the other? Is that a change in accounting principle or a change in accounting procedure?

A. I said that it was a change in accounting procedure in my opinion. I also said that hopefully each of them would have achieved the overriding principle, the result of lower of cost or market.

Q. Directing your attention specifically to what Thor did in 1964 in the manner of computing its [216] excess inventory. Have you an opinion as to whether Thor acted in accordance with generally accepted accounting principles?

A. It is my opinion that they did on the basis of what I know and have seen and have read.

Mr. Abrams: Your Honor, I have nothing further of Mr. Trueblood with respect to the inventory issue. Would you prefer to have Mr. Sherman cross examine Mr. Trueblood on that issue, or the direct on bad debts by Mr. Berens will be very brief.

Mr. Berens: We can do it either way.

The Court: I will leave it up to Mr. Sherman.

Mr. Berens: I've got about three questions.

Mr. Sherman: Why don't you just ask them?

Direct Examination by Mr. Berens.

Q. Mr. Trueblood, I refer you to Petitioner's Exhibit 18, which describes the bad debt analysis for computing its reserve as of December 31, 1965, and ask you if you are familiar with that exhibit?

A. I have reviewed it.

Q. As a matter of generally accepted accounting principle or procedure or either, is the method they used reasonable in your opinion?

[217] A. That is not an uncommon method. The ultimate result, I mean the ultimate test is whether the reduction of the four million nine to four million six accomplished a net realizable presentation in the statement, in the balance sheet, but the application of percentage factors to an aging of the account is not at all unusual and rather common.

Q. If you would compare this aging method that they used and applying different percentages to it, and I am not asking whether these percentages are reasonable or not, but just the method of aging the accounts and varying different percentages, if you compared that as a matter of general accounting principles to taking a six year average of the bad debt experience of the taxpayer, which method would more likely show an accurate result?

Mr. Sherman: If the Court please, I believe this is—here is a general question now. This is extremely speculative. If you will look at the particular taxpayer, you will almost necessarily get a different result—I believe that the question is highly speculative as to which method would show a more reasonable result.

Mr. Berens: Your Honor, I have asked for his opinion on this matter. The issue before the Court [218] as stated yesterday by Mr. Sherman, is whether the Government's six year moving average is arbitrary or not. I have asked this expert who is qualified in the accounting field to compare out method, our client's method with the method that the Revenue Service would force on the client for tax purposes.

The Court: I will overrule the objection.

By the Witness:

A. First, the technique described on Petitioner's Exhibit 18 I would call a procedure as distinguished from a principle.

I would also call a moving average percentage determination a procedure.

Now, in my own experience there is some difficulty with moving averages of past experience in the sense that what we are really trying to do from an accounting point of view is to determine the future realizability of the existence of collectibility of those accounts receivable.

Now, the economy of next year or the next year or the next year might be quite different than the economy of the past five or six or ten years. So, I would prefer frankly to look at the future in terms of existing receivables rather than to arbitrarily apply a past experience ratio, although as we talked about in the case of inventories, one has to consider [219] past experience, but it would appear to me that there was explicit consideration, at least in some of these categories, to the nature and the probable collectability of particular accounts which I prefer to the sheer or straightforward matter of application of past experience.

Q. Do I understand correctly that in your opinion the moving average method overvalues the past and does not take into sufficient consideration current and future events as compared to the aging method?

Mr. Sherman: I object to the leading nature of the question and I ask that the Court in evaluating the answer of the witness take into account the manner in which the question has been asked.

The Court: I will sustain the objection to the question.

By Mr. Berens:

Q. Let me restate the question.

What defect, if any, does the moving average method have?

A. The moving average method may put too much credence or support on past economic or business activities which may or may not be representative of future expectations.

Q. Does it take into account any current or [220] future factors?

A. Strictly applied, it takes into account not future expectations.

Q. In your opinion, does an aging system with specific evaluations take into account present and future factors?

A. Yes, sir.

Mr. Berens: That is all on direct.

The Court: Mr. Sherman.

Mr. Sherman: I just have a couple of questions.

Cross Examination by Mr. Sherman.

Q. Mr. Trueblood, I take it then that you don't think too highly of using the taxpayer's own six year past history with respect to bad debts, am I correct in that, in order to determine the reserve addition? In order to determine the reserve to bad debts, you don't think that the six year prior bad debt history is adequate?

A. It is a useful piece of information, but let us say that we had a portfolio of $100,000,000 of receivables in Client "X", and the past year history had a 2 per cent bad debt experience based on sales of "X", and let us say that we had a single account in [221] that $100,000,000 portfolio which is zero. It would be only by chance that past history gave recognition to that unusually bad account.

Q. In summary, then, you feel that the use of the past bad debt history, given a five or six year period, has some defects, is that correct?

A. I do, and if a client of ours were to use a straight moving average on a retrospective basis, we would require in addition an item by item aging and analysis of the present portfolio.

Q. On the other hand, the use of the one year past history as indicative of future sales is entirely reliable, is that what you also testified to?

A. I testified that typically that is all of the information we had available.

Q. But is it reliable as a projection of future sales?

A. It is typically used as the only available—

Q. I am asking you again, is it reliable?

A. It is not necessarily completely reliable, no, sir.

Q. Can you state it more strongly than that? Isn't one year a pretty poor—

A. I wouldn't say that.

Q. —period in which to use for projections?

[222] Mr. Abrams: Your Honor, I think these questions, although rather argumentative, don't have anything to do with comparison. Words such as "poor"—poor as compared to what?

Mr. Sherman: Your Honor, the witness—

Mr. Abrams: May I finish my objection? Mr. Sherman continually complained about the impropriety about hindsight, you have to use foresight. I would think the Respondent should be in some way compelled to take one tact or the other in the course of his case rather than jumping back and forth on either side. If the hindsight is no good and the foresight is no good, the taxpayers are helpless.

Mr. Sherman: If the Court please, this is cross examination. This witness has testified in favor of a method which takes a one year sales history and projects that, and speaking, I assume, from the other side of his mouth he now says that six years aren't really that reliable as a projection if you are talking about bad debts and his client doesn't want to use the [Black Motor] formula. I would like to know which side the witness would like to come down on.

The Court: I will permit you to test this witness' opinion on these matters. It isn't clear in my mind what you mean when you talk about the one year [223] experience.

Mr. Sherman: The one year usage on the inventory.

The Court: Well, are you equating his opinion on inventory with his opinion on bad debts?

Mr. Sherman: No, what I am asking is if he takes the position that with respect to bad debts, the six year past history is not reliable, but at the same time wishes to take the position with respect to inventory valuation, that using the past sales history of one year is reliable as a projection of future sales.

Mr. Abrams: I have no objection to that question, Your Honor, if that is what Mr. Sherman wants to ask.

The Court: I understand the question now, so you can answer that question.

The Witness: Will you restate the question?

By Mr. Sherman:

Q. Well, I would ask again if the use of a one year past history of sales in order to project future sales is a sufficient period for a liability.

A. Well, Your Honor, I have some difficulty because I don't see the difference.

The Court: I don't understand that question [224] at all now that you are talking about liabilities. We have only been talking about assets in this case, either the asset or the account receivable or the asset of the inventory.

Mr. Sherman: I was talking about reliability. Whether the one year period, the one year past sales history is a reliable basis on which to project future sales value.

The Court: Now you are talking about sales.

Mr. Sherman: That is correct. This was in connection with the inventory issue, the formula that was used in 1964 sales as the basis—

The Court: I don't understand the formula to be based on that. It is based on usage, isn't it?

The Witness: That is right.

Mr. Sherman: I'm sorry. Let me change the question.

By Mr. Sherman:

Q. Do you feel that one year usage is a sufficient testing period to be reliable as a projection of future usage?

A. Now you are confining it simply to one year usage on inventory being reliable as an estimate of forward sales?

Q. That is correct.

[225] A. It is a reasonable approach.

Q. But is it a reliable basis upon which to estimate your future usages?

A. Future usages?

Q. Yes.

A. It is a reasonable basis.

Q. I see. And on the other hand, six years is not, in your opinion, a sufficient period of time or a reliable basis upon which to estimate your future bad debt experience?

A. Mr. Sherman, I don't want to be difficult, but there is a lack of analogy between the two situations, because you first asked—or am I not permitted to say this?

The Court: If you don't answer his question that way, I'm going to ask you a question to explain it.

Mr. Sherman: I won't ask another question, Your Honor. No further questions.

The Court: Mr. Abrams?

Redirect Examination by Mr. Abrams.

Q. Would you explain, Mr. Trueblood, the distinction which you draw between the two situations referred to by Mr. Sherman in his last question?

[226] A. Well, the difficulty I had with it—I may have misunderstood some of the earlier questions. The difficulty I had with it is we are always trying to get to net realizable value, whether it be inventories or whether it be receivables. I understood that the six year average in the receivable situation had to do with an experienced percentage of loss. I wouldn't quarrel with six years as being a reasonable averaging of past experience, six or ten or two or three or what have you, but what I got hung up on is that typically I do not see the validity

of past experience on bad debt losses in relation to forward experience on a presently existing portfolio.

It might be the same, it might be vastly different. This is why I used that, you know, unusually worthless $10,000,000 account. Averages for any period of years in the past might not touch that, and yet from the standpoint of an auditor I've got to get that $10,000,000 down to zero, whatever past experience. Now, maybe I misunderstood.

Q. If in the case of your valuation for excess inventory there were certain specific items similar to this worthless $10,000,000 item in the accounts receivable area, would some special adjustment in addition to the formula be necessary?

[227] A. It would be necessary and quite appropriate.

Q. Is that similar, in your opinion, to the adjustment described in Petitioner's Exhibit 13, that LaGrange Park, referred to there as Speedway?

A. That is Exhibit 13, Speedway and Cincinnati Rubber. That is precisely in point in your last question.

Mr. Abrams: Nothing further of this witness, Your Honor.

Mr. Sherman: Nothing further.

* * *

[229] Mr. Abrams: Petitioner's next witness will be Bertrand J. Belda.

BERTRAND J. BELDA was called as a witness on behalf of the Petitioner, and, having been first duly sworn, testified as follows:

The Clerk: Be seated, sir. State your name and address for the record.

The Witness: My name is Bertrand J. Belda. I live at 33 Lyman Circle, in Shaker Heights, Ohio.

[230] *Direct Examination by Mr. Abrams.*

Q. What is your profession, Mr. Belda?

A. I am a Certified Public Accountant.

Q. How long have you worked in public accounting?

A. Thirty-one years.

Q. You are now with what accounting firm?

A. The firm of Ernst & Ernst.

Q. In the Cleveland office?

A. Yes, in the national offices, which are in Cleveland.

Q. How long have you been with Ernst & Ernst?

A. Thirty-one years.

Q. What is your present position with Ernst & Ernst?

A. I am partner in charge of management consulting services.

Q. For the entire national organization?

A. For the entire firm.

Q. How long have you held that position?

A. Eight years.

Q. In what areas of the practice of accounting have you specialized in in the bulk of your practicing career?

[231] A. Primarily in management accounting, with particular emphasis on cost accounting, profit planning, budgeting, forecasting, inventory valuation and similar areas pertaining to accounting.

I might add, though, that I have also covered other non-accounting areas in the course of my practice, operations of businesses and the like.

Q. What general principles are considered by accountants in valuing assets for balance sheet purposes?

A. The general principles applicable to the valuation of assets recognize the economic and conceptual values of costs applicable to most of the assets.

I might add a very important modification that in the case of current assets, those that are likely to be realized in the

course of a year or in the course of a business cycle, that a very careful valuation is made of its realizable or economic or utility value as an amendment to or an adjustment to cost.

Q. What general principles do accountants apply in preparing income statements, profit and loss statements?

A. The principle thrust of income accounting [232] is to match realized revenues with the cost of obtaining those revenues. In doing so, however, the accountant is mindful of the effort to attribute to a given period of time an appropriate amount of income, net income, which is the difference between the revenues and the costs and expenses, the appropriate amount that is attributable to all of the actions or lack of actions that might have occurred in the business during that period of time.

The relationship of the income statement to the balance sheet is very important because any asset carried over in the balance sheet which is not realizable in subsequent periods represents a serious charge to subsequent periods, which it does not deserve.

In essence, the income statement should pick up all items of costs which are not appropriately carried forward to future periods.

Q. How do those principles apply particularly to the valuation of inventory?

A. Well, in inventory, the cardinal principle is one that is expressed succinctly as cost or market, whatever is lower. This is consistent with what I just expressed about the modifications of cost when and if there is some indication that utility of the [233] inventory might be impaired in terms of its realization.

Q. In general accounting terminology, how would you define "excess inventories"?

A. Generally I would call it inventory in excess of what can reasonably be expected to be sold in the ordinary course of business.

Q. With any particular reference to price levels?

A. No. As a matter of fact, excess inventory frequently occupies a rather peculiar position. Unlike market adjustments, which may be made in view of some price softness in the market, excess inventories are those which cannot be sold regardless of price.

A typical example is in the retail business, in a department store. Merchandise that might be out of date, out of current vogue is frequently offered at prices less than the original sale price in an effort to move the merchandise, and it usually is successful.

In August, department stores will be selling bathing suits at a fraction of their previous price, and by and large most of those bathing suits will be moved because of the price attraction to the customer.

In the case of excess stocks, however, it doesn't make much difference what price you offer the [234] merchandise at. If there isn't a need for it and a good use for it, no one will buy it. And that is an important distinction I think here to recognize in dealing in the cost or market concept, because I believe in the case of Thor that is what we are talking about.

Q. Could you give an example of an excess situation as distinguished from a bathing suit situation that you described?

A. A typical example is the repair part problem. Manufacturers of units, or products comprised of many components frequently change their model, style to include alternative components or components of different characteristics. When that is done, there is frequently a problem of obsolescence in the existing stocks of components for the old unit. But offsetting that is frequently a need for repair parts, service parts to maintain existing units in the hands of customers.

The repair parts stock needs to be tailored to the expected demand, and very often as components are changed, as models are changed, the existing inventory is not the improper balance to recognize the need for these repair parts.

I might go on and emphasize what I mentioned before. If we think in terms of a 1957 Ford automobile, they continue

to be on the streets and occasionally there is a need for a repair part, but the quantity of those repair parts is likely to decline over the years as the number of those models reduce through junking and other loss of utility, but the company who manufactures that is expected to be able to serve whatever customer needs do arise.

In that connection, anything in excess of what is reasonably expected to be used as a repair part is obviously excess stock and has no value except as possible scrap value.

Q. What do generally accepted accounting principles state as to the proper accounting treatment as to excess inventory?

A. Excess inventory for accounting purposes under generally accepted accounting principles is a category of many different and similar categories which I believe the generally accepted accounting principles refer to as loss of utility. This includes excess stocks, it includes damaged merchandise, it includes obsolete merchandise, it includes, oh, a variety of perhaps imperfect merchandise and so on, all of which are regarded as being important to recognize under the cost or market theory, and also I [236] might add der an old accounting axiom of anticipating no profits, particularly when there is evidence that indicates that there is some doubt about its realizability.

Q. So you have to write it down?

A. Write it down, that is correct.

Q. Do you have to wait until the item is scrapped to write it down when it is in this category?

A. In accounting, the evidence that indicates a lack of utility should be recognized as soon as that circumstance can be identified without regard for any physical disposition of the merchandise.

Q. Would it be proper to wait to write it down until you actually scrap it?

A. Absolutely not. In fact, one of the great hazards in business, especially a manufacturing business, is the risk of carrying inventory which may not be realized.

Q. Are these principles relating to the write down of excess to its net realizable value mandatory or optional?

A. They are mandatory under generally accepted accounting principles.

Q. What would happen if a client of your firm had excess inventory but refused to write it down? [237] What action would your firm take?

A. Well, we would have no alternative but to deny approval of the financial statements. When I say deny that, it would either be an exception and/or a denial of our opinion as to their fair presentation, assuming that it is of some significance.

Q. From the point of view of accounting theory, if a company is accounting for its inventory on lower of cost or market, is there any difference between a write down in market and a write down of obsolete inventory items?

A. The impact in terms of income and the balance sheet are identical, and again they come under the same category of loss of utility, and there isn't any difference, no substantive difference. We categorize these as to causes and reasons for lots of purposes, but the economic and accounting impact is identical.

Q. Is the theory of write down for excess the same as the theory of write down for obsolete?

A. Yes, it is. Both relate again to the loss of utility.

Q. Do generally accepted accounting principles authorize the use of a formula as distinguished from an item by item analysis of formula write down of [238] excess inventory? By "formula," I mean by some reference to prior usage.

A. Oh, I would think, particularly in the excess stock situation, the determination of the quantities which are excessive is one that involves a careful analysis which is fundamentally aimed, the point I tried to make a moment ago, aimed at eliminating from the inventory any value that will not be realized in the future.

In doing so, it is apparent that the future needs to be assessed, an estimate needs to be made of what the prospects are. You might generalize, too, that in any kind of forecasting, a major, a fundamental basis is a knowledge of the history of what has happened in the past. This is true in the weather or in economic phenomena. It is the use of the past experience which gives us a clue as to what is likely to happen in the future.

Accordingly, depending on the kind of merchandise, the kind of company, the seriousness and the like of the situation, the estimate is concerned with determining an approximate quantity that is expected to be sold.

Now, in doing so, that involves a formula of determining the amount of items to be sold, either [239] on the one hand on an item for item basis, and in other cases certain tests, certain types of statistical analysis may in fact give at least equal and sometimes even superior results than an item for item kind of analysis.

In answer, yes, formulas are very common.

Q. Prior to testifying here this afternoon, have you reviewed the statutory notice of deficiency that was filed with respect to Petitioner's 1964 income?

A. Yes, I have.

Q. And the Petition which the taxpayer filed with this Court?

A. Yes, I have.

Q. Have you also looked at the Answer and the Amended Answer in this case?

A. I've seen the Answer, but not the Amended Answer.

Q. Have you seen the Stipulation of Facts?

A. Yes, I have.

Q. Have you seen the exhibits that have been received in evidence in this case?

A. Well, some of them I'm not sure that I have.

Q. The ones in particular, Exhibits 13, 17, 18, 19, 20 and 22.

A. Yes, I have seen those.

[240] Q. And are those the exhibits which you have with you?

A. That is right.

Q. The ones I have furnished you. And you also heard the testimony or some part of the testimony of Mr. Trueblood this morning?

A. Yes, I did.

Q. Have you an opinion as to whether generally accepted accounting principles permitted Thor to write down its excess inventory in 1964?

A. Well, I would go further than that. I would say more than permitted, I think they demanded it from the indications and the information I have been able to obtain.

Q. On the basis of the materials that you have reviewed, to which I have referred, have you an opinion as to the action which you and your firm would have taken if you had been Thor's auditors in 1964 and Thor had refused to write down its excess inventory?

A. I think we would have had a serious problem with regard to the fairness of presentation of the balance sheet and the income statement for that year, and if the company refused to recognize this problem through appropriate accounting adjustments, we would have either taken exception or denied an opinion.

[241] Q. Now, Mr. Belda, directing your attention to Paragraph 8(b) of the Stipulation, which appears on page 5, particularly the facts stipulated therein that in 1964 Thor had 44,000, approximately 44,000 inventory items of which more than 33,000 were finished parts and accessories. Have you an opinion as to whether generally accepted accounting principles permitted Thor to use a formula based on prior usage as a means of determining the amount of the write down for excess inventory?

A. I wonder if you could repeat that question. (Whereupon the record was read.)

By the Witness:

A. To answer that, I would say that the objective and generally accepted accounting principles is to produce a sound inventory value in accordance with those principles. The technique used should be in consonance with, in agreement with that objective.

As a practical matter, I would, with the large number of items involved here, think that a formula approach is probably the only practical means of carrying out that objective. However, I do want to emphasize that I regard that as a technique to achieve a principle as opposed to being a principle.

Q. Directing your attention now, Mr. Belda, to [242] the Stipulation of Facts, Paragraph 9(c) on page 6, the description there of the formula utilized by Thor in 1964 indicates the full value was attributed to inventory items equivalent to one year's anticipated usage, partial value within the second year and no value at all to inventory items to be more than two years anticipated usage.

Does that formula appear, in your opinion, to be consistent with generally accepted accounting principles as far as theoretical reasonableness is concerned?

A. Well, I don't know that reasonableness can be completely theoretical. I would say this kind of formula and the amounts used are consistent with the range of values that I am accustomed to seeing in many companies, particularly those that produce units which involve repair part service as well as one time sales.

I think it is in the area of reasonableness, but I might also add, there is a convention relating to inventory valuations and all current asset items which gives strong emphasis to recognizing those values that can be realized within a year or a normal business cycle. The amounts attributable to that which is in excess of the year is probably a little [243] less—well, results in carrying inventories beyond a year's supply, which is a little unusual, a little less conservative, as I would say that most companies, as a general rule, would consider.

Q. The application of the convention to which you just referred in 1964 by Thor would have then increased the amount of the write down?

A. Yes, yes. If I calculated it correctly, I believe those items in excess of a year's supply constitute about another 37 and a half per cent add on beyond the year's supply. Now, I don't know how significant that is. I have made no calculations of it, but if it were of great significance it could even conceivably produce some balance sheet problems because you have stated as a current asset some inventory that won't be realized for more than a year. Frequently when that is of serious consequence, the classification of that item on the balance sheet is moved from the current asset position to non-current.

Q. Application of the convention of writing down all inventory items in excess of one year's supply in 1964 would have had what effect on Thor's income?

A. It would have reduced its income below that which has been stated.

[244] Q. Now, Mr. Belda, directing your attention to Petitioner's Exhibit 19, The Summary of Test of Reserve for Excess Inventory Conducted by Arthur Anderson & Company.

A. Yes.

Q. What conclusions have you drawn on the basis of this exhibit with respect to the credit to Thor's reserve for excess inventory, assuming that the formula referred to in Paragraph 9(c) of the Stipulation was applied consistently by Thor during each of the years 1964 through 1971?

A. Well, in order to assess this, I took a look at the footnotes, which indicate the basis of the tests that were applied, also at the proportions, and they seem to be reasonable, have some statistical validity.

As I see the application, I note that in both years the reserve appears to have been understated, in the case of 1970 by $36,000, or, if I understand this correctly, the reserve was about 17 per cent less than was required.

The situation was somewhat closer in 1971, but there, too, the indication was that the reserve, based on these tests, was—that a reserve, a write down was needed, but it also indicates, if you [245] extrapolate this and apply it to the rest of the inventory, that it was probably not enough.

Q. The reserve was probably not enough?

A. That's right.

Q. And conversely, the inventory was overstated?

A. That's right. That is on the basis of this information that I have here.

Q. Directing your attention now to Petitioner's Exhibit 20, captioned "Summary of Income Statement, Domestic Consolidation."

A. Yes.

Q. Do you have an opinion on the basis of this exhibit as to the reasonableness of Thor's reserve for excess inventory?

A. Well, I'm not certain that I can draw any significant conclusion, with this possible exception, that in using history to project the future and using the sales figures that I see here and the trend in sales, it appears rather evident that the sales in 1966, for example, were not indicative of '67, in fact they were optimistic, and this is generally true through the entire exhibit. That is one indication that I might draw from this.

The company obviously has been suffering some economic difficulties. Sales are over—let's [246] see, that's a ten year period or less than half what they were for the earlier years. I think possibly this might have contributed to some operating problems which accounts for the production or acquisition of stocks of merchandise in excess of what could be sold. In this case, the prediction was based upon more optimistic results than were actually obtained. Those are observations I would gather from—

Q. Do those factors lead you to the opinion as to whether the reserve at the end of 1964 was higher than it should have been?

A. No. If anything, it would indicate to me that it was possibly a little short of what it might have been. However, I would again emphasize that in developing a formula of this character, I would give some great weight to the opinions of the management and its circumstances, its particular product lines and what is happening to them. But in general, I pointed out that one of the important cornerstones of a forecast is analysis and an understanding of the past, but also that isn't the end of it. I think you need to understand the causes of what happened and to be able to project these into the future. In fact, it is the basis of most management judgments that are made.

Q. Now, Mr. Belda, directing your attention to [247] Petitioner's Exhibit 22, "Reserve for Excess and Obsolete Inventories."

A. Yes.

Q. Have you an opinion on the basis of that exhibit as to the reasonableness of Thor's procedure for computing its reserve for excess inventory?

A. Well, according to these data, I observed that the total provision for the eight years under review here aggregates some $6,000,000. I also observed that the dispositions in the next to last column of obsolete and excess inventories during that same period total $4,000,000. I inquired particularly with regard to the year '64, as there are no dispositions included there, and I understand that information wasn't available about those dispositions. If we exclude the year '64, we find that the provision, if I calculate correctly, was about $2,400,000 against actual dispositions of over $4,000,000. This leads me to conclude with regard to 1964, at least, a substantial reserve and/or write down and/or write off, all of which have no substantive difference, was imperative, that there was indeed excess stock and obsolete merchandise on hand that required adjustment.

Q. Now, Mr. Belda, directing your attention to Petitioner's Exhibit 17, described as "Analysis of [248] Dispositions at Aurora and Los Angeles."

A. Yes.

Q. Have you an opinion on the basis of the data shown therein as to the reasonableness of Thor's write down for excess inventory in 1964?

A. Well, it's quite evident, if I read this correctly, and the summary, that the amounts of 1964 reserve and/or write down in the amount of 847,000, approximately, for these two units was subsequently disposed of or, as this indicates, three-quarters or 78 per cent were subsequently disposed of as being obsolete.

Just kind of looking back indicates from the evidence here that at least 78 per cent of that reserve was necessary by subsequent events, but I am also quite aware of the fact that the difficulty of identifying many thousands of parts and its subsequent disposition, such that under ordinary circumstances that the identified amount is probably not all.

Q. Mr. Belda, let me direct your attention specifically to the Summary Line 2, which states that the $847,000 to which you referred applied to Los Angeles and Aurora and the branches, whereas the dispositions referred to in Line 3—

A. Oh, excuse me.

[249] Q. —are only from Los Angeles and Aurora. Does that fact alter your opinion?

A. Yes, I didn't note that. To whatever extent branch data is included in the 847,000, the dispositions would account for a higher percentage of the write off.

Q. And that would have what effect on your opinion as to the reasonableness of the 1964 inventory?

A. Greater support for the need for the write off, or write down or reserve.

Q. And for the reasonableness of the amount of the write down?

A. Yes, yes.

Q. It has been suggested, Mr. Belda, that you may have referred in your explanation of your opinion on the basis

of this exhibit to obsolete. You do understand that this is the tabulation of only excess inventory and not obsolete, Exhibit 17?

A. Since you so inform me, all right. It isn't labeled, I guess.

Q. Will you assume that it is excess?

A. Yes.

Q. I think we will have no problem with Mr. Sherman. It was stipulated to on the basis of being an exhibit relating to excess.

[250] A. All right.

Q. Now, Mr. Belda, I direct your attention to Paragraph 10 of the stipulation, beginning at the bottom of Page 6 and continuing on to Page 7, which describes a supplemental procedure that was used for the write down for excess on various inventory items as to which the formula could not be accurately applied, and to Exhibit 13, which tabulates the amount of the write down of $160,000 that resulted from the adjustments described in Paragraph 10 of the stipulation.

A. Yes, I have that.

Q. On the basis of your experience, have you an opinion as to whether generally accepted accounting principles permit the application of or the utilization of such an additional write down, even though the company in question is applying a formula write down for excess as to the bulk of its inventory?

A. Well, as I understand it, this portion of the inventory did not lend itself to the application of the formula. By that, from information I have, the usage with regard to the Speedway and Cincinnati Rubber portions were not available.

However, in connection with the company's entire operation, the specific evidence developed in [251] terms of usage data for the rest of the inventory would cause me to be concerned about this other portion, and it would lead me to question whether or not, or to question whether, if you will, the same kind of problem existed here.

If the indications were that a similar situation existed, the fact that I didn't have specific data would certainly not alleviate the need to recognize prospective, or existing, I should say, loss of utilization which needed to be recognized.

In looking over the portions ascribed to the items, and that was, I imagine, reserved or stipulated as reserved, these seem to be nominal amounts, with the exception of the hardware portions. When I saw the 50 per cent figure, I inquired of the company management and was advised that the reason for that was that much of the hardware could not be identified with particular part numbers and the like.

In effect, apparently it was a kind of inventory that really had—whether or not it had use was perhaps second to the fundamental operating problem that they couldn't identify where it might be used, and in a large company with many parts, unless you have that information, even if the stuff is in stock, you don't know where it is usable.

[252] So, accordingly, that 50 per cent figure seems to be justified in this case with that added explanation. The others are rather nominal amounts and I would have little doubt but that they were necessary.

Q. And in your opinion appropriate, even though a formula was being applied elsewhere in the inventory?

A. That's right.

Q. On the basis of generally accepted accounting principles and terminology, Mr. Belda, can it appropriately be said that what Thor did in accounting for its inventory at the end of 1964 was lower of cost or market inventory accounting?

A. Yes, and that conforms to generally accepted accounting principles.

Q. Under that term?

A. Yes.

Q. Do generally accepted accounting principles prohibit the use of certain kinds of reserves against inventory?

A. Only those that might be capricious or contingency or profit equalization kinds of reserves are those that would not be recognized.

There must be a sound, justifiable basis [253] for any write down, whether it is achieved through the use of a reserve or whether it is directed against the item themselves.

Q. Could you give examples of the types of reserves which are not approved by generally accepted accounting principles, inventory reserves?

A. Oh, frequently, or maybe not today because they are not recognized as generally accepted accounting principles, but over the years, years ago it was not unusual for a company in its conservatism to apply round number reserves just in anticipation of potential price changes of certain kinds of shortages of other contingencies which weren't identified or weren't applicable.

Since these kinds of reserves were not identified, the accounting profession found them useless in the sense that they could not be restored to income and/or increased based upon some kind of evidential justification, so contingency reserves generally became unacceptable as a generally accepted accounting principle, not accepted, and any kind of such blanket or arbitrary inventory reserves also became unacceptable.

Q. Was the reserve for excess inventory utilized by Thor in 1964 that type of prohibitive [254] reserve?

A. Definitely not. This was determined on the basis of a considerable amount of analysis, particularly with regard to the tools, which, I guess, were the bulk of the inventory.

Q. Even though it related to the contingency of what would or wouldn't be sold in the future?

A. Well, this was existing inventory that evidence clearly indicated could not be sold.

Q. Under these circumstances, is there any difference from the point of view of generally accepted accounting principles between the use of a reserve as a contra account on one hand

or simply writing off the books the inventory that is regarded as excess?

A. Not at all. They both accomplished the identical purpose.

Q. Do generally accepted accounting principles recognize a distinction between a change in accounting principles on the one hand and a change in accounting procedures on the other?

A. Very much so, yes. Principles are seldom changed, but techniques, practices, procedures constantly change in most companies because of changing conditions, circumstances and the like.

[255] Q. Would you characterize a change from the cash receipts and disbursements basis to the accrual basis as a change in principle or a change in procedure?

A. That is a change in principle.

Q. In the case of accounting for long-term contracts, how would you describe a change from the percentage of completion basis to the completed contract basis, a change in principle or a change in procedure?

A. That is a principle change.

Q. How about a change from the LIFO to FIFO inventory or vice versa?

A. That is another change in principle.

Q. Or a change from accelerated depreciation to straight line depreciation or vice versa?

A. Also a change in principle.

Q. A change in computing a bad debt reserve from an age of account basis to a percentage of sale basis, is that a change in principle or a change in procedure?

A. No, that is a technique or a procedural change.

Q. How about a change from computing depreciation on the basis of lives of individual items to computing it on the basis of lives of groups of items?

[256] A. Again, that is a procedural change, which is in both instances aimed at maintaining the same accounting principle.

Q. How about a change from computation of inventory quantities by complete count to computations through use of sampling techniques?

A. Another procedural change.

Q. A change from allocating overhead on the basis of labor dollars to allocating it on the basis of machine hours?

A. That is a procedural change. Very common, by the way.

Q. Assuming that the only write down for excess which Thor used in 1963 was accomplished in the manner described in Paragraph 6 of the Stipulation of Facts, to which I direct your attention. If that was the only manner in which a write down for excess was computed in 1963, and that in 1964 the write down for excess was computed in the manner described in Paragraphs 9 and 10 of the Stipulation, Paragaph 9(c) being the formula to which we have referred and Paragraph 10 being the additional write down of the $160,000, assuming that in '63 only the Paragraph 6 basis was used and in '64 the other. Would you describe that as a change in accounting principle or [257] a change in accounting procedure?

A. A change in accounting procedure. Here again the principle remains the same, to recognize the deterioration of utility value, which is part of the cost or market.

Q. On the basis of your experience and the factors which you have considered, do you have an opinion as to whether Thor's write down of its inventory as of December 31, 1964 for excess was in accordance with generally accepted accounting principles?

A. Yes, it was.

Mr. Abrams: Your Honor, I have nothing further of this witness with respect to the inventory issue.

If Mr. Sherman has no preference, perhaps we can have Mr. Berens ask a few questions about bad debt reserves before cross-examination on all issues.

The Court: Very well.

Direct Examination by Mr. Berens.

Q. Mr. Belda, have you had a chance to review Petitioner's Exhibit 18?

A. Yes, I have.

Q. Would you describe generally the system used by the Petitioner as evidenced by that exhibit in [258] evaluating its bad debt reserve at the end of 1965?

A. As I understand this exhibit, it is an analysis of the account receivable status at the close of 1965, which considers various categories of the receivables as they stood at the date and their respective collectabilities.

As I gather from this exhibit, the company, through the process of aging its accounts receivable, that is to say, categorized them as to the period of time that the accounts were past due, or not past due—first I should say not past due and then those that were past due—and taking past due as evidence of questionable collectibility, sought to establish appropriate reserves for uncollectible accounts based on that analysis.

I might add that apparently certain of the larger account balances were identified as being substantially all uncollectable, and, as I presume, that was the information about the debtor that the company was able to obtain.

Q. In your opinion, is this method that was used of aging accounts and applying different percentages to the different agings and of evaluating hard core collectability a satisfactory method under generally accepted accounting principles?

[259] A. Yes, it is a satisfactory method.

Q. Would you compare from the standpoint of generally accepted accounting principles that method with the method of taking a six-year moving average for calculating the reserve based on the actual experience during those six years of the particular creditor?

A. Well, I would answer that and say both methods have been used. The moving average method takes cognizance of some history, but the fact that many years, six years are used

as opposed to one, two, five or some other number, does not contribute much more validity or reliability, particularly in view of the fact that some of the data is old data.

I would think if I were going to use history alone, I would be more likely to recognize current information or more current information to give it greater weight. However, in certain kinds of establishments, particularly small loan companies with literally millions of accounts, banks among others, it is not unusual to use a moving average experience, and particularly where credit losses are statistically controlled.

However, an analysis of the specific situation with regard to the status of the accounts as they [260] were at the close of the year, as they existed, I think is generally superior to the moving average history, and I would think it is rather evident as to why it is superior simply because it takes far more specificity as to the individual accounts.

As I say, the history and large numbers of accounts is a convenient way. I don't know how many accounts Thor had at the end of 1965, but I would doubt that they were millions in number.

Q. Well, if history is an important factor, would not a history of ten years, or in the case of Thor, which has been in existence for 80 years, wouldn't an 80-year history be better?

A. Well, that is a fallacy. The more ancient history that you inject into these experiences, the less valid it is in terms of current operating practices. The management of Thor 80 years ago was certainly far different than it is currently. I think I can make that statement safely.

Credit policies tend to change with economic conditions, with supply, demand, competition. Credit is an instrument of sales, and credit is tightened on occasions and expanded on other occasions. So, it isn't something that tends to be constant at all, but it changes under prudent management. And the [261] condition of the accounts as they stood at the end of 1965 represented the current status of management decisions and the extension of credit.

If, as indicated here, the accounts over $100, a hundred and sixty-one thousand of that amount, of the total amount, was, as it is called, "hard core," extremely doubtful of collection, it seems to me that that ought to be recognized.

Here again the objective is to avoid carrying forward a receivable which is doubtful of collection.

Q. Under the moving average system, do I understand correctly that if there was only one debtor who was bankrupt, that—I am going to try to rephrase that question. Strike that.

Do I understand correctly that under the moving average system a reserve would be permitted even though the accounts receivable were entirely one creditor who was bankrupt?

A. Using that method, this would be the result, but it would be an obvious inappropriate result.

Q. Let me pose the converse. If there was six years of experience showing a certain amount of uncollectability for various customers, but now this particular company was selling, let us say, to a [262] single customer, General Motors or the United States Government, would it be appropriate on the moving average to apply, by this mechanical method, to apply reserve for bad debts even though it is a single customer whose credit is no question?

A. In that extreme, the obvious answer is that the technique would be inappropriate. Incidentally, one reason why techniques or procedures need to be changed, to adjust to the circumstances as they currently exist. Again, the reason why, this kind of analysis tends to be superior to the statistical variety.

Mr. Berens: No further questions.

Mr. Sherman: No questions, Your Honor.

The Court: Thank you, Mr. Belda.

The Witness: Thank you.

Mr. Abrams: As we have previously advised Your Honor, regrettably, the scheduling has prevented us from going—oh, Mr. Belda.

Mr. Berens: Mr. Belda, would you stay on the stand a moment.

Mr. Abrams: I have technically rested with respect to this witness, Your Honor. May we reopen to ask him a few other questions which were omitted?

The Court: Surely.

[263] *Direct Examination (Resumed) by Mr. Abrams.*

Q. Mr. Belda, has the Division of Federal Taxation of the American Institute of Certified Public Accountants expressed an opinion with respect to the treasury regulations in connection with accounting for excess inventory for tax purposes?

A. Yes, it has.

Q. Are you familiar with the details of that opinion?

A. Yes, I am, quite familiar with it.

Q. Would you state generally what the opinion as expressed is?

A. Yes,—

Mr. Sherman: Objection, Your Honor. I believe now we are getting into the field of the province of the Court. I don't believe that the opinion of any private organization with respect to the issue before the Court, which will have to decide the validity and interpretation of those regulations, can possibly be the subject of expert testimony.

Mr. Abrams: If Your Honor please, first of all, we are not, of course, expecting that the views of the American Institute or of any private organizations are dispositive of any issues before the Court. [264] However, we have here the rather unusual position, the situation that the Internal Revenue Service itself requested comments from the accounting profession with respect to the proposed regulations. The comments were in fact submitted by various private accountants, private individuals or firms, and by the Division of Federal Taxation of the AICPA to the Internal Revenue Service. My understanding is that hearings were to be held in May of this year with respect to the

proposed regulations, but that after receiving certain written comments the Internal Revenue Service itself postponed the hearing.

Mr. Belda, as I will elicit if permitted to go on with him, participated very actively in drafting of the written report which the AICPA Division of Federal Taxation submitted to the Commissioner of Internal Revenue, and indeed Mr Belda is the author of the particular section of that report which we have here and will propose to mark and introduce as a Petitioner's Exhibit, the particular portion dealing with what the regulations should provide with respect to excess inventory.

That is obviously not controlling, dispositive of the issues in this case. I believe it is very relevant as an expression of opinion by the [265] organized accounting profession as to what the regulations should provide.

At the moment the regulations are silent on the question of excess. It is for that reason that I undertake this line of interrogation.

Mr. Sherman: I don't believe, Your Honor, that any reason or any basis for the admissibility of this evidence has been stated.

We are still dealing with a question of law. There are many regulations with respect to which hearings are held, there are many verbose changes in the regulations, and anyone, any individual, any organization is free to render their opinion, to send in a written opinion with respect to their views as to how the regulations should be changed or whether the regulations should or should not be changed or whether a particular proposed regulation should or should not be adopted.

It appears to me that if the door is opened to this sort of thing, then it could be opened to just about anything.

We could have a million letters, because a million people chose to send in an opinion with respect to proposed regulations.

Mr. Abrams: In this case, Your Honor, [266] however, the regulations as they stand talk about the best accounting method

that most clearly reflects the taxpayer's income. In our view of the case, which I understand to be different than Mr. Sherman's, the concepts of generally accepted accounting principles and the view of the accounting profession are exceptionally relevant.

We have present and available for cross examination the man who wrote the position that was adopted by the AICPA Division of Federal Taxation and submitted it to the Internal Revenue. Again it is not dispositive of questions of law which face Your Honor, but we believe it is certainly relevant for Your Honor's determination of what best accounting, generally accepted accounting principles are in this situation and what methods of accounting best and most clearly reflect the taxpayer's income.

It is for that reason that we seek to introduce the views of the accounting profession as they have been so adequately expressed through the opinion of this witness.

The Court: Well, since the regulations are silent on the issue before the Court and the views of the American Institute of Certified Public Accountants was solicited by the Treasury Department [267] in proposing regulations in this area, I trust that if the regulations are adopted after the hearings are conducted, that they probably won't be applicable to the years before the Court.

If you will lay the proper foundation with this witness to show his participation in the report, through his testimony rather than just through your representations, I think it should have a material bearing on the issue in this case, because although many views may have been submitted to the Treasury before the hearing, and, of course, I have no knowledge of how many, but I would think the views of the American Institute of Certified Public Accountants would be entitled to great weight, particularly since the regulations in the Code make reference to generally accepted accounting principles.

I offhand know of no body—and I don't mean that in one word, it sounds like a double negative—I don't know of any group of individuals or any organizations that can express an

opinion as to generally accepted accounting principles better than the American Institute of Certified Public Accountants.

So I am going to overrule the Respondent's objection and permit this witness to testify to the contents of that report.

[268] Mr. Berens: Your Honor, for the Court's information, I would like to point out, and I have been looking for the memo and I can't put my hands on it, that the amendment of Treasury regulations is retroactive unless it is detrimental to a taxpayer. So, if these regulations were amended, they may well control the year '64, because it would not be in this case, assuming they were amended as the American Institute proposes, they would not indeed be detrimental to the taxpayer.

Mr. Abrams: I hope they amend it soon.

By Mr. Abrams:

Q. Mr. Belda, rather than asking the reporters to look for the last pending question, did you participate in the drafting of the comments of the Division of Federal Taxation of the American Institute of Certified Public Accountants with respect to proposed regulations regarding valuation of inventories?

A. Yes, I did.

Q. Who is the chairman of the Committee that prepared this report?

A. Robert G. Skinner.

Q. Your relation to Mr. Skinner is what?

A. He is my partner.

[269] Q. Did Mr. Skinner elicit your assistance in the preparation of this report?

A. Yes, he did.

Q. Showing you a document which has been marked for identification as Petitioner's Exhibit 29, I ask you whether this is a copy of the report which the Division of Federal Taxation submitted to the Internal Revenue Service on April 17, 1972.

A. Yes, it is.

Q. Were you personally responsible for writing various portions of this report?

A. Yes, I was. I drafted a substantial portion of this paper. In fact, most of those that relate specifically to valuations as opposed to those relating to technical questions on regulatory changes and methods of adopting the new regulations, which I think are tax administrative matters as opposed to valuation matters.

Q. Have you, on the original of this report, the original of this copy from which this exhibit was Xeroxed, indicated with pencil lines in the margins those portions which you personally drafted?

A. I don't know whether I've got them all, but I think I've got most of them.

Q. But at least those portions which do bear [270] the marks in the margins were drafted by you?

A. Yes. I have pencil marked those lines which I authored.

Q. Directing your attention specifically to Pages 4 and 5, dealing with, and I quote on Page 4:

"The problem of determining appropriate costs for inventory quantities in excess of prospective demand."

A. Yes, sir.

Q. Did you write that section?

A. Yes, I did.

Mr. Abrams: Your Honor, I offer in evidence as Petitioner's Exhibit 29 the document which has just been described.

Mr. Sherman: Respondent objects for the reasons previously stated.

The Court: Very well. The objections are noted and the Exhibit will be received in evidence.

(The document previously marked for identification as Petitioner's Exhibit No. 29 was received into evidence.)

Mr. Abrams: Thank you, Your Honor. I have no further questions of this witness. You may cross. Hopefully I have no further questions of this witness [271] at all.

Mr. Berens: Your Honor, before we—

The Court: Do you wish to cross-examine, Mr. Sherman?

Mr. Sherman: I have no questions, Your Honor.

The Court: Thank you. You may be excused.

* * *

[26 June 1972]

[283] Mr. Abrams: Petitioner's next witness will be Newman T. Halvorson.

NEWMAN T. HALVORSON, was called as a witness on behalf of the petitioner, and, having been first duly sworn, testified as follows:

The Clerk: Be seated, please, sir, and state your name and address for the record.

The Witness: Newman T. Halvorson, Woodstock Road, Gates Mills, Ohio.

Direct Examination by Mr. Abrams.

Q. What is your profession, Mr. Halvorson?

A. I am an independent public accountant.

Q. How long have you been in public accounting?

A. Since 1930.

Q. With what firms of accountants have you practiced since that time?

A. During all of that time with Ernst & Ernst. From 1930 to 1954 in its Detroit office, and from 1954 until now in its national office in Cleveland.

Q. What were your duties and responsibilities [284] when you were in the Detroit office of Ernst & Ernst?

A. They always had to do with auditing and financial reporting. From 1930 until 1940 as a field auditor, and from 1940 to 1954, primarily as a reviewer of audit working papers

and reports and financial statements that were being issued by clients of ours.

Q. During that latter part in the Detroit office, were you the senior man responsible for reviewing the field auditing of manufacturing audits?

A. In the office I was. In other words, as papers and reports came in from the field to the office, I was the principal reviewer during the last ten or twelve years, yes.

Q. What have your responsibilities been since you went to the national office of Ernst & Ernst in 1954?

A. They have still been connected with auditing and financial reporting, although the amount of field auditing has been minimal, essentially not at all, although I have retained some connections with some clients of the firm in various parts of the country.

Q. What is your overall role now in Ernst & Ernst with respect to auditing and accounting and financial reporting standards?

[285] A. I am called the partner in charge of technical auditing and accounting services, which includes, among other things, primary responsibility for our practice before the Securities and Exchange Commission and published financial reporting generally.

Q. As partner in charge, that means you are in charge for the entire firm of Ernst & Ernst nationally in this respect?

A. In a staff sense, yes, not in a line sense. I do not direct our auditors. I try to answer their questions and try to see that we are maintaining appropriate standards and adhering to appropriate reporting practices.

Q. About how many professionals does Ernst & Ernst employ in the United States, professional accountants?

A. As of now, I believe between four and five thousand.

Q. On what committees of the American Institute of Certified Public Accountants have you served?

A. Beginning about 1955, I was on the Committee on Accounting Procedure, which was the senior committee responsible for accounting principles and accounting theory and so on generally.

[286] It was a group of 21 men, I think, that had that responsibility for our organized profession. It went out of existence in 1959.

Then, after a lapse of about two years I was appointed to the AICPA Committee on Auditing Procedure, which was the senior committee responsible for auditing and reporting practices for the profession.

I served on that committee until 1966, at which time I resigned to accept an appointment to the Accounting Principles Board.

The Accounting Principles Board was created in 1959 to succeed to the old committee on accounting procedure and did become the most authoritative body within the American Institute of CPAs on matters of accounting principles and good financial reporting generally. I am still on that body, on the Accounting Principles Board.

I have also served two one-year non-consecutive terms on the AICPA Committee on Relations with the SEC and the Stock Exchanges, which was more or less a liaison committee between those organizations and the American Institute of CPAs.

Q. About how many members are on the Accounting Principles Board at any given time?

[287] A. For the last several years there have been 18.

Q. In preparing a balance sheet or reviewing balance sheets, what general principles are applied with respect to valuation of assets?

A. The basic presumption is that assets will be stated at cost, historical cost. Then there are some overriding conventions which may suggest that cost on occasion will be reduced in view of surrounding circumstances, but you begin with the premise that cost is the appropriate basis.

Q. And what general factors are considered in asset valuation with respect to the preparation of income or profit and loss statements?

A. Generally speaking, you attempt to anticipate losses as soon as they are evident. You recognize declines in market values in many instances.

If your realizable value or your recoverable value is less than the recorded cost, you try to look at the utility of an asset and recognize diminution in value, if its utility has declined or deteriorated.

Other costs you spread around among the periods of usefulness, such as depreciation of plant and amortization of various types of deferred costs and so on.

[288] Q. How do you apply those principles to accounting for inventory?

A. Again you begin with the basic presumption of cost, but there is a rule of lower of cost or market, which is an inescapable rule which suggests—that demands that at any time at which an inventory has declined in value or in usefulness below cost, you will write it down to what we call market, and market may be replacement cost if you can replace the item at less than it cost initially, or you may have to write it down to realizable value.

In case the proceeds that you expect to enjoy from its disposal are not enough to recover the cost, a reduction of market will be obligatory.

Q. Under generally accepted accounting principles, what is the appropriate treatment of excess inventory?

A. Well, excess inventory will be considered inventory which you will not be able to dispose of in the ordinary course of events at a price sufficient to recover the cost you have in it, so it will be written down to what I would consider to be its market price, which may be a scrap value in extreme cases. It may be a reduced selling price in other cases.

It may be an effort to price it at an amount [289] which will be not greater than the net realizable value of the item or items.

Q. Do you have to wait until an item is physically scrapped before writing it down as excess?

A. Not at all. I think we have in practice regularly and frequently instances where excess stocks are being reduced to let us call it anticipated, realizable amounts without the physical scrapping occurring.

Q. Is the principle relating to writing down excessive inventory an optional one or is it mandatory?

A. It is mandatory.

Q. What would happen if your firm were auditing the financial statement of a manufacturing company which refused to write down its excess inventory? What action would your firm take?

A. We would have to issue a qualified opinion saying that we did not believe the financial statements presented the financial position and results of operations to conform with generally accepted accounting principles. Depending on the extremity of the difference, we might have to go so far as to express an adverse opinion or even disclaim an opinion, but in any event, it would be a qualified opinion. [290] We could not say we had a fair presentation.

Q. In the case of a company which is accounting for its inventory on the lower of cost or market, is there any substantive difference between a write down to market and a write down of obsolete inventory items?

A. From an accounting point of view, no.

Q. Is there any theoretical difference between a write down to market for excess or a write off of unsaleable items which are obsolete?

A. I don't think so.

Q. Do generally acceptable accounting principles permit the use of a formula based on prior usage as a means of writing down excess inventory?

A. The accounting principle runs to the value established for inventory. The formula could be a thoroughly acceptable

accounting procedure or auditing procedure for arriving at this market value.

Q. Under what circumstances would generally accepted accounting principles permit the use of such a formula?

A. Typically where you have a vast aggregate of separate descriptions of inventory, no one of which maybe is extremely large individually, but collectively they are important, and the sheer [291] mechanics of trying to arrive at individual evaluation of every specific inventory item or description makes it almost prohibitive, so you arrive at a formula approach that can be applied effectively and expeditiously and arrive at what would be essentially the same desired end.

Q. Can you use a formula which is based on prior usage as a means of estimating future usage?

A. Oftentimes it is based on prior usage. Sometimes a formula will be based upon the age of the item. The effect, however, would be similar, and based on usage would be a typical instance. Based on prior usage would be a typical instance.

Q. Have you in your experience observed companies which you were auditing using formulas for writing down excess inventory?

A. Yes.

Q. And have you regarded this as in accordance with generally accepted accounting principles?

A. Completely.

Q. Prior to your testimony here this morning, have you reviewed the Statutory Notice of Deficiency which was submitted to the taxpayer in this case?

A. Yes.

Q. Have you also reviewed the Petition which [292] the taxpayer filed in this Court?

A. Yes.

Q. And the Answer which the Respondent filed to that Petition?

A. Yes.

Q. Have you also reviewed the Stipulation of Facts?

A. Yes.

Q. And have you reviewed Exhibits 13 through 27? That is, 13, 17 and 18 I think you have before you. 14 through 16 and 23 through 28 are the spread sheets, Mr. Halvorson.

Let me show you an example of Petitioner's Exhibit 23, which is entitled Summary of Inventories and Valuation Reserves. This one, Exhibit 23, is as of November 30, 1967.

A. I have seen them.

Q. The other ones—

A. For five years, on through 1971.

Q. Yes.

A. I have seen them. In response to your question, Exhibits 13, 17, 18, 19, 20 and 22, I guess it is, yes, I have reviewed them.

Q. And 14 through 16 and 23 through 28, Mr. Halvorson, are the spread sheets for each of the years?

A. That's right.

[293] Q. I am sorry. I am told it is through 27, not through 28.

Based on your review of those materials and your general experience, Mr. Halvorson, have you an opinion as to whether generally acceptable accounting principles permitted Thor to write down its excess inventory in 1964?

A. Yes.

Q. What is your opinion?

A. That Thor was not only justified but in retrospect I think would have been compelled to make a provision for excess stocks in 1964.

Q. If you had been the authorized auditor at that time and Thor had refused to write down its excess inventory, what action would you have taken?

A. We would have qualified our opinion on the financial statement as being not in conformity with generally accepted accounting principles.

Q. Mr. Halvorson, directing your attention now to the Stipulation of Facts, and in particular Page 5 thereof, Paragraph 8(b) in the middle of that page describes the number of inventory items that Thor had at the end of 1964 as being 44,092 items.

Considering that fact, have you an opinion as to whether generally accepted accounting principles [294] permitted Thor to use a formula as a means of determining the amounts of write down for excess?

A. I think a formula was permissible and desirable.

Q. I'm directing your attention now, Mr. Halvorson, to Paragraph 9(c) of the Stipulation, which describes the particular formula which Thor used in 1964 to write down its inventory for excess. That is a formula which afforded no inventory value to items in excess of two years of anticipated usage.

Have you an opinion as to whether that formula appears, just the formula alone, to be consistent with generally accepted accounting principles?

A. I think the formula just looked at alone would be consistent with generally accepted accounting principles.

The specific nature of the formula would be a judgmental thing, but as a formula, it would be acceptable to me.

Q. Does it appear to be generally consistent with formulas that you have observed in the course of your experience as being used by other companies?

A. It would have the same general thrust or import, yes.

Q. Now, Mr. Halvorson, directing your attention [295] particularly to Petitioner's Exhibit 19, which is the Summary of Tests of Reserve for Excess Inventory prepared by Arthur Andersen and Company, and assuming that throughout each of the years after 1964 through and including 1971, Thor wrote down its excess inventory using the formula that is described in Paragraph 9(c) of the Stipulation, have you any opinions, have you formed any conclusions on the basis of this exhibit, as to

the reasonableness of the procedures which Thor followed for writing down its excess inventory in 1964?

A. Yes, I have.

Q. What is your opinion?

A. Exhibit 19 would suggest that the formula was accomplishing its intended purpose and possibly was creating less of a reserve than might be required based upon actual experience; that the provisions being made were something less than the requirements demanded.

Q. Directing your attention now, Mr. Halvorson, to Petitioner's Exhibit 20, the Summary of Income Statement Domestic Consolidation for the period of 1962 through 1971, have you an opinion, on the basis of this exhibit, as to the reasonableness of the write down for the excess inventory which occurred at [296] Thor at the end of 1964?

A. Looking at the trend of Thor's sales from 1964 on through 1971, which show a steady decline year-by-year, it would suggest to me that an estimate of usage on which a formula is predicated would probably result in a reserve that may be even less than necessary because usage estimated in one year, in the face of what appears to be declining sales will probably turn out to be less than actual usage and at the same time the progressively declining sales would suggest that the accumulation of excess stocks may continue, that production in one year may prove to be greater than requirements, so that the condition for which the formula reserve is provided would be a continuing one.

Q. Now, Mr. Halvorson, directing your attention to Petitioner's Exhibit 22, captioned Reserve for Excess and Obsolete Inventory Domestic Consolidation—

A. I have it.

Q. Have you an opinion on the basis of this exhibit and the data shown therein, as to the reasonableness of Thor's write down for excess inventory at the end of 1964?

A. Yes, I do.

Q. What is that opinion?

[297] A. Again it is my opinion that the reserve, the provisions to the reserve would be, appear to be reasonable year by year.

There have been significant disposals of excess stock, but the condition demanding continuing additions to the reserves had not disappeared.

The dispositions are those, as I understand it, which were actually identified and accounted for as being dispositions of excess stock in the inventory at the end of 1964.

The probabilities are that the actual dispositions, either by scrapping or failure to maintain the necessary records for precise accounting for disposals, would result in a condition where the actual disposals will have been greater than the ones recorded as such.

Q. Now, Mr. Halvorson, directing your attention to Petitioner's Exhibit 17 which is captioned Analysis of Dispositions at Aurora and Los Angeles—

A. Yes.

Q. Have you an opinion on the basis of the data shown in this exhibit as to the reasonableness of Thor's 1964 write down for excess inventory?

A. Yes, I do. This exhibit shows in the summary at the end of it that the reserve created in [298] 1964 in the amount of $1,000,000, $1,079,000 included $846,000 attributed to inventory at three locations, Los Angeles, Aurora and branches, thinking of branches as being a single location; whereas in the years since that reserve was created, the dispositions from the Los Angeles and Aurora locations alone without regard to what may have been occurring at the branches, amounted to $657,000.

So that it seems to me that when dispositions to date have accounted for something like 78 per cent of the reserve provided, that the need for the reserve is quite clearly demonstrated and the amount of it seems to be quite consonant with the demand.

Q. Now, Mr. Halvorson, would you direct your attention to Paragraph 10 of the Stipulation, beginning at the bottom of Page 6 and going over to the top of Page 7, and also after you have looked at that would you look please at Petitioner's Exhibit 13.

Both Paragraph 10 of the Stipulation and Petitioner's Exhibit 13 relate to credits to the reserve for excess inventory valuation in the amount of $160,000, which were computed on a basis other than the formula described in Paragraph 9 of the Stipulation.

A. Yes.

[299] Q. Do generally accepted accounting principles permit such additional write downs even though a company is using a formula for writing down excess inventory as to parts of its inventory?

A. Yes.

Q. Under what circumstances?

A. A corporation, a manufacturer or any other business may use different procedures for arriving at inventory valuations for different parts of its inventory.

If the appropriate records for applying the formula are not available, the manufacturer or the business would have to turn to some other method, to some other procedure for arriving at similar valuation and the application of percentages to inventory categories as was done in this instance is completely sound accounting, completely appropriate procedure.

Actually a procedure such as this could have been superimposed on a formula. If indications were that the formula might not be accomplishing all it was designed to do, one might still go into an overriding percentage determination.

That is not what was done here, but I say it would be acceptable, permissible and sometimes may be necessary.

[300] Q. Under generally accepted accounting principles, would it be appropriate to characterize Thor's manner of accounting for its inventory at the end of 1964 as lower of cost or market?

A. I think that is what it was, yes.

Q. Do generally accepted accounting principles prohibit the use of certain kinds of inventory reserves?

A. Not if the reserves are created to really measure the decline in the market value of the inventory.

Arbitrary reserves, no, but reserves that are designed with some sophistication to accomplish the ends of lower of cost or market are completely acceptable.

Q. What kind of arbitrary reserves are not acceptable under generally accepted accounting principles?

A. Reserves which were whimsically designed to achieve a profit manipulation or something of that kind which were not geared to appraisal of the conditions that made the reserve appropriate.

Q. Would you characterize the reserve for excess inventory utilized by Thor as an arbitrary reserve or one permissible under generally accepted accounting [301] principles?

A. Not at all arbitrary and completely permissible.

Q. From the point of view of substance, is there any difference in accounting theory between establishing a reserve for excess inventory on the one hand or alternately simply writing off the excess inventory without reserving for it?

A. From an accounting point of view and a financial reporting point of view, no difference.

Q. Do generally accepted accounting principles and terminology recognize a distinction between a change in accounting principles on the one hand and a change in accounting procedure on the other?

A. Yes.

Q. Generally stated, what is the difference between the two?

A. A change in the accounting principles would create an inconsistency in financial statement preparation, so that the results determined in one year would not be consistent or comparable with results in a preceding year.

So that the auditor would have to draw attention to that fact and state in his opinion that there has been an inconsistency and

the effect of it, [302] if material, would be disclosed in the financial statements. Whereas, a change in accounting procedure would merely be applying the same principles as have been applied before, but the procedures in arriving at the principles may have varied from the accounting standpoint and also from the auditing standpoint.

Q. Would you characterize a change from the cash receipts and the disbursements basis to an accrual basis as a change in principle or a change in procedure?

A. That would be quite a significant change in principle if one assumes that the cash basis of accounting had validity in the first place.

Q. How about in the case of accounting for long-term contracts, a change from the percentage of completion basis to the completed contract basis of accounting?

A. That would usually be regarded as a change in accounting principle. There is quite a different approach in how income is being determined.

Q. How would you characterize a change from LIFO to FIFO inventory valuation or vice versa? Is that a change in principle or a change in procedure?

A. That would be a change in principle.

Q. How about a change from accelerated [303] depreciation to straight line depreciation or vice versa? Is that a change in principle or a change in procedure?

A. That is a borderline situation, but it probably comes nearer to being a change in principle in arriving at your depreciation charge.

Q. How about a change in computing a bad debt reserve from an age of account basis to a percentage of sales basis?

A. That I think would be a procedural approach to arrive at a satisfactory or sufficient bad debt reserve.

Q. Would you call it a change in procedure rather than a change in principle?

A. Yes.

Q. How about a change from computing depreciation on the basis of lives of individual items to computing it on the basis of lives of groups of items?

A. I think that, too, would be a change in your procedure for calculating depreciation, not a change in principle.

Q. How about a change from computing inventory quantities by complete count to computing them on the basis of sampling techniques?

A. That certainly would be procedural and not [304] principle.

Q. How about a change from allocating overhead on the basis of labor dollars to allocating it on the basis of machine hours?

A. That, too, I think, is clearly a change only in procedure.

Q. Have you an opinion, Mr. Halvorson, if you will assume for a moment that the only change—strike that—that the only basis used by Thor for computing credits to its reserve for excess inventory in 1963 was on the basis described in Paragraph 6 of the Stipulation—Paragraph 6 of the Stipulation describes the basis or a basis used for computing credits for the reserve to excess in the years prior to 1964—

A. Yes. My copy at the moment is so faint I am having difficulty identifying Paragraph 6, but—here is No. 5.

Q. Paragraph 6 deals with—I will let you read it, Mr. Halvorson. Here comes a more legible copy.

A. No, I read it, but I can't decipher it in this copy at the moment. Yes.

Q. Assume that that was the only basis on which Thor computed credits to its reserve for excess [305] inventory in 1963, and that Paragraph 9 and 10 of the Stipulation describe the manner in which Thor computed credits to its reserve for excess inventory at the end of 1964—that is the formula that we have been discussing—and the additional credit of $160,000 described in Paragraph 10 of the Stipulation, have you an opinion as to whether there was a change in accounting prin-

ciples or a change in accounting procedure by Thor in this respect?

A. I think it was purely a change in accounting procedure. The principle still was to arrive at a lower of cost or market valuation and the resort to a formula or the adoption of a formula, you can say, was a refinement, if you will, of a matter previously used. It was directed toward exactly the same principle of accounting, a procedural approach which was changed to arrive at this same end.

Q. Have you an opinion, Mr. Halvorson, as to whether Thor's write down of its inventory, as of December 31, 1964 to account for excess was in accordance with generally accepted accounting principles?

A. Yes, I do. I think it was.

Mr. Abrams: Your Honor, I have nothing further with respect to the inventory issue, but consistent with respect to the practice we followed [306] Friday, Mr. Berens will examine on the bad debt issue before cross examination.

The Court: Very well.

Direct Examination by Mr. Berens.

Q. Mr. Halvorson, I direct your attention to Petitioner's Exhibit 18 which I believe you have there, entitled Analysis of Bad Debt Reserve Requirement as of December 31, 1965, and ask you if you have reviewed that document?

A. I have.

Q. Could you describe generally, based on that document, what the Petitioner did in evaluating its bad debt reserve for that year?

A. Yes. Looking at the exhibit beginning with its inter-company accounts, the conclusion was that no reserve was required for collection of them.

Going down to the trade accounts with the customers, not the inter-company accounts, the conclusions differed somewhat, depending upon the nature or the condition of the accounts and

in some cases a 100 per cent reserve was provided against specific accounts and a reserve equal to either one or two per cent of the unpaid balance was applied to other accounts in arriving at the appropriate reserve, at [307] the end of 1965.

This was based on the age of the accounts. As I understand it, at most of the locations, accounts, current accounts were considered to be subject to a reserve of one per cent. Accounts somewhat older than that were subject to a reserve provision of two per cent, and in certain cases accounts which were 90 days or more past due, on which there appeared to be serious credit problems, were covered by a 100 per cent reserve on the basis of their age at that particular time.

Q. Do you consider a 100 per cent reserve for certain hard core accounts to be consistent with generally accepted accounting principles?

A. Yes, I do.

Q. Is this a fairly customary thing in your experience for companies to take this sort of reserve on specifically identified accounts?

A. Yes, it is.

Q. Do you have an opinion as to the validity of this system which takes into account past and current data as compared with a mechanical system wherein the actual experience of a particular taxpayer over six years is used as a basis of its bad debt reserve?

[308] A. Yes.

Q. Would you state that opinion?

A. I think typically the more current the information is upon which one predicates a bad debt reserve, the better the reserve will be, the more precise it will be, if you will; that a review of the accounts as they exist as of a given date offers a better basis for providing a reserve than would a statistical approach predicated on experience over a period of time.

Q. Assuming that the difference would be material, would you withhold an unqualified opinion if the mechanical approach, in your opinion, resulted in an inadequate reserve?

A. Yes, we would withhold an opinion if the reserve appeared to be inadequate without regard to how it was arrived at.

Mr. Berens: No further questions.

Mr. Sherman: I just have a couple of questions.

Cross Examination by Mr. Sherman.

Q. With respect to the excess inventory matter, if we assume that at the end of 1963 Thor's condition with respect to excess inventory also existed in [309] approximately the same, to approximately the same extent as it did at the end of 1964, would you, if you were the independent accounting firm for Thor, have also required, in order for an unqualified certification, would you have also required Thor to write down its inventory as of December 31, 1963?

Mr. Abrams: Your Honor, I object to the question on the ground it assumes facts that are not in evidence.

Mr. Sherman: I said if it be assumed, Your Honor. This is a hypothetical question.

Mr. Abrams: Proper hypothetical questions, Your Honor, are to be based on facts in evidence. I understand Mr. Sherman does not have the intention of putting on any evidence with which he could connect this question up.

Mr. Sherman: If the Court please, I believe the question, I believe the foundation does exist in the pleadings which Thor has filed and in the Stipulation to which it was a party. I regret that it is necessary now to take these pleadings apart and read them. I think counsel for the Petitioners is aware of what Thor's pleadings state.

Mr. Abrams: If Mr. Sherman states that the fact is of record, Your Honor, I will withdraw my [310] objection without making him go through all those papers at this time.

The Court: Very well, you may answer the question, Mr. Halvorson.

By the Witness:

A. Yes. Usually you would recognize in the accounts the effect of an inventory deterioration or a loss at the time it was first recognized, and if it could be demonstrated that the inventory at the end of 1963 had been stated in error, there might be a case for going back and reconstructing the 1963 financial statements to reflect at that time some of the deterioration.

It would be quite unusual in respect of inventories, however, to find that condition existing. Although, not knowing myself anything of the surrounding facts vis a vis '63 and '64 here, I can't give you an answer as to what we might have done at that particular time.

By Mr. Sherman:

Q. But going back now to the question that you were asked on direct examination with respect to whether you would qualify your statement if you were Thor's auditors in 1964 and this fact came to your attention, wouldn't you give the same answer with [311] respect to 1963 if the same question were asked, except that the year in question was 1963?

A. If we came to the 1964 inventory and had previously expressed an opinion on the 1963 inventory without qualification, I would have to assume that we had been satisfied, based upon the evidence in hand at the end of 1963, that that inventory had been stated at the lower cost or market at that time and, therefore, would not go back and change it or introduce a qualification retrospectively; but you must understand that the size of the 1964 provision was, let us say, large in relation to the year. It could be that there is in there some element of unrecognized past excess. I don't know.

Q. If you had been the auditors for Thor in 1964 and you were satisfied that the only procedure which had been previously used for writing down inventory had been the procedures adopted in Paragraph 6 of the Stipulation of Facts, the 10 per cent amortization of the parts and accessories for items no

longer currently produced, and that the procedures described in Paragraphs 9 and 10 of the Stipulation of Facts had first been adopted in 1964, would you provide any notation or other statement as part of the profit and loss statement to indicate such change?

[312] A. I don't believe I would. I would consider that in each case a diligent effort, if you will, and appropriate judgmental factors are being applied to arrive at a lower cost or market and that the fact that the procedure had not been the same in the two years would not require financial statement disclosures or mention in the auditor's reports.

Q. In other words, from the point of view, I take it, of generally accepted commercial accounting procedures, this would not be considered a change requiring any particular comment and/or notation with respect to the profit and loss statement?

A. In my opinion it would not require a comment either in the note to the statement or in the auditor's report on the statements.

Mr. Sherman: No further questions.

Redirect Examination by Mr. Abrams.

Q. Mr. Halvorson, in your opinion what is the best basis for determining the year in which a particular excess inventory actually became excess?

A. What is the best means of determining the year that it became excess?

Well, I don't know if there is a best year. You look at each year as it comes and consider the [313] record, if you will, as to what the past performance in respect of the item is and what the future performance may be, and try to arrive at a determination at the time, year by year. So—

Q. But if you determine that particular year that an item is at that time excess,—

A. Yes?

Q. —how do you determine when it actually became excess?

A. I think I would determine that the excess arose at the time it was first identified as such.

I still don't quite know how to answer your question. How do you determine the year in which it became excess?

I should imagine, as I say, you look at past performance and you estimate future performance, and once they get out of balance, experience shows you what you are going to use or what your judgment tells you what you are going to show in the future is the year in which the excess emerges.

Q. And in your view it becomes excess when it is first identified as being excess?

A. That is when you would first give accounting recognition to it, but you say when it becomes excess would be a factual thing, but the information to make [314] the determination might not be there, if you will.

Q. If in a particular year management determines that certain items appear to be excess—

A. Yes?

Q. But there are factors indicating that management should have made that determination earlier with respect to those items, what is the appropriate accounting treatment?

A. In the ordinary case I believe the excess would be given recognition at the time the determination was made, even though there may be indications that the condition may have been a creeping one or a latent one. Typically you do not go back and undo what has been done unless it is a very aggravated situation indeed.

Mr. Abrams: I have no further questions, Your Honor.

Mr. Sherman: No further questions.

The Court. Thank you, Mr. Halvorson.

(Witness excused.)

* * *

[315] Mr. Abrams: Petitioner would like to call as its next witness Mr. H. B. Burris.

HOWARD BARRY BURRIS, was called as a witness on behalf of the Petitioner, and, having been first duly sworn, testified as follows:

The Clerk: Be seated, please, sir, and state your name and address for the record.

The Witness: Howard Barry Burris, B-u-r-r-i-s, 58 Far Brook Drive, Short Hills, New Jersey.

Direct Examination by Mr. Abrams.

Q. What is your profession, Mr. Burris?

A. I am a Certified Public Accountant.

Q. How long have you been in public accounting?

A. Since 1950.

Q. With what firm are you presently associated?

A. I am presently associated with S. D. Leidesdorf & Company as an audit partner.

Q. In which office of that firm do you work?

A. In the New York office.

Q. How long have you been with S. D. Leidesdorf & Company?

[316] A. I began with Leidesdorf in 1954 as staff auditor. I was a staff auditor from '54 through 1960, a manager with them to '65. In 1965 I left Leidesdorf to take a position in private industry, as a treasurer of a company, and returned in 1966 and I have been an audit partner with them since then.

Q. In which phases of public accounting have you principally been occupied since you joined Leidesdorf?

A. Almost exclusively as an audit partner dealing with commercial organizations, manufacturing companies and the like.

Q. On what committees of the American Institute of Certified Public Accountants have you served?

A. I am presently a member of the Committee on Auditing Procedure which is the senior technical committee on auditing authorized to issue pronouncements on auditing procedures for the profession.

Q. Would you state generally the considerations which apply in valuing assets for balance sheet purposes?

A. Assets generally would be valued for balance sheet purposes at cost reduced in those instances to net realizable value or fair value in those circumstances where warranted, generally at cost.

[317] Q. What goals do you seek to achieve in valuing assets for income statement purposes?

A. The purpose of valuing assets for income statements would be a proper matching of costs and revenues, to have the costs fall in the proper period, the valuations fall in the period that an expense should occur.

Q. How would you apply the principles you have just described to valuation of inventory?

A. For balance sheet purposes, inventory would be valued in accordance with generally accepted accounting principles at the lower of cost or market, so that at balance sheet date we would have a valuation at cost reduced to a net realizable value concept, which in turn would result in a proper matching of costs and revenues for income statement purposes.

Q. What is net realizable value?

A. Net realizable value is a criteria for determining market value. It has upper and lower limits.

Market value is defined as replacement costs which will not exceed net realizable value, that is, sales price less cost of completion and cost of disposal, the lower limits being the net realizable value reduced by a normal gross profit margin.

[318] Q. What treatments do generally accepted accounting principles require with respect to excess inventory?

A. Excess inventories should be reduced in value from cost to its net realizable value to arrive at the lower of cost or market concept.

Q. How would you define "excess inventory" from an accounting point of view?

A. Excess inventory would be that quantity of inventory in excess of normal business requirements that cannot be disposed of or probably may not be disposed of at its normal selling price.

Q. Do you have to wait until an item is actually scrapped before you write it down as excess?

A. Absolutely not. You should write down inventory at the time you recognize that it is excess or will not result in sales at normal prices.

Q. Is that an optional procedure or a mandatory one, writing down of excess?

A. That is a mandatory procedure which is required by the concept of lower of cost or market.

Q. If you were the auditor of a manufacturing company which refused to write down its inventory for excess, what action would you take?

A. We would refuse to issue an unqualified [319] opinion, we would issue a qualified opinion. If the amount involved were material and we were able to determine the amount, we would probably issue an adverse opinion.

Q. In the case of a company that accounts for its inventory on the lower of cost or market, is there any substantive difference between a write down to market and a write down of obsolete items?

A. Would you repeat the question?

Mr. Abrams: Would you read it back please?

(Whereupon the record was read.)

By the Witness:

A. No, there is no substantive difference at all. The obsolete item write down would be in line with the concept of writing down to market.

By Mr. Abrams:

Q. Is there any substantive difference between a write down for excess and a write down for obsolete?

A. No, the principle is the same.

Q. Do generally accepted accounting principles permit the write down of excess inventory through the use of a formula based on prior usage?

A. Absolutely. A formula method of write down, that procedure would be consistent with generally accepted accounting principles.

[320] Q. And is it permissible to use prior usage as the basis for the formula?

A. Yes, the prior usage generally would be a very good barometer and indicator of future requirements. A formula based on prior usage is a very common way of writing down obsolete and excess inventories.

Q. Under what circumstances do generally accepted accounting principles permit the usage of a formula as a means of computing a write down for excess?

A. Generally, where the specific identification on an item by item basis would be impracticable or cumbersome, such as an inventory with a great number of units where a large quantity of inventory, relatively homogeneous in type, would lend itself to a formula basis.

Q. In the course of your auditing experience, have you observed and approved the use of formulas based on prior usage as a means of writing down for excess inventory?

A. Many times.

Q. Prior to your testimony this morning, Mr. Burris, have you had an opportunity to observe the Statutory Notice of Deficiency that was issued to [321] the taxpayer?

A. Yes, I did.

Q. Did you also observe the petition that Thor filed in this cause?

A. Yes.

Q. And the Answer of the Respondent to that petition?

A. Yes.

Q. Have you also reviewed the Stipulation of Facts?

A. Yes.

Q. Have you had an opportunity to examine Exhibits 13 through 19—pardon me, 13 through 20, and 22 through 27?

A. Yes, I did.

Q. On the basis of your review of those materials and your general experience, have you an opinion as to whether it was appropriate in accordance with generally accepted accounting principles for Thor to write down its excess inventory in 1964?

A. On the basis of reviewing the procedure used at December 31, 1964 and the subsequent events as shown by the exhibits, it is my opinion that it was mandatory for them to write down that inventory, the excess quantities, to be in accordance with generally [322] accepted accounting principles.

Q. If you had been Thor's auditor at the end of 1964 and Thor had refused to write down its inventory to reflect excess, what action would you have taken?

A. We would have refused to issue an unqualified opinion. Our opinion would have been qualified or we might have disclaimed an opinion on those statements.

Q. Now, Mr. Burris, directing your attention to the Stipulation of Facts, and in particular Page 5, Paragraph 8(b), which describes the number of inventory items, the different types that Thor had at the end of 1964. On the basis of that portion of the Stipulation, have you an opinion as to whether generally accepted accounting principles permitted Thor to use a formula as a means of writing down its excess inventory?

A. Yes, that inventory consisted of 44,000 separate items, and it is my opinion that 44,000 items would make the use of a formula method almost obligatory. It would not be practicable to value that inventory for lower of cost or market on an item by item basis.

Q. Now, Mr. Burris, directing your attention [323] to Page 6 of the Stipulation of Facts, and in particular Paragraph

9(c), which describes the formula which Thor used at the end of 1964. Have you an opinion as to whether that formula appears to be theoretically consistent with generally accepted accounting principles?

A. Yes, the use of a formula in this case or in any case is a procedural matter. The generally accepted accounting principle is the lower of cost or market. The procedure used with respect to this formula is a reasonable formula, and its application would be consistent with the lower of cost or market concept, which is a generally accepted accounting principle.

Q. Would it be consistent with generally accepted accounting principle, or was it, to use a formula which gave no value to inventory items in excess of two years' anticipated usage?

A. Yes.

Q. Have you in the course of your experience observed and approved formulas used by other companies which gave no value to inventory items in excess of two years' anticipated usage?

A. Yes.

Mr. Sherman: Object to it. It is [324] irrelevant.

Mr. Abrams: Your Honor, I think the extent to which this witness has observed similar formulas goes to the weight of his opinion—observed and approved them as being in accordance with generally accepted accounting principles goes to support his testimony as to the propriety of this particular formula used in this case.

The Court: I will overrule the objection. I think it is relevant to establish the weight of his testimony as an expert.

Mr. Abrams: Would you read the question back please?

(Whereupon the record was read.)

By the Witness:

A. Yes. The determination that there is no value to inventory in excess of a given period of time will vary. I have seen formulas where no value is given to inventory in excess of one

year. Past usage and historical needs plus the gross profit rate and many relevant circumstances will determine at what point no value is given, but certainly no value being given to two years is not inconsistent with generally accepted accounting principles and is a reasonable basis.

[325] By Mr. Abrams:

Q. Have you approved formulas used by clients of yours that gave no value of inventory in excess of one year anticipated usage?

A. Yes.

Q. Now, Mr. Burris, would you direct your attention, please, to Petitioner's Exhibit 19, which is captioned "Summary of Tests of Reserve for Excess Inventory by Arthur Andersen & Company."

In considering that exhibit, Mr. Burris, assume that Thor used the same formula which is described in Paragraph 9(c) of the Stipulation for valuing its excess inventory during each of the years from 1964 through 1971. On the basis of that assumption and your review of Petitioner's Exhibit 19, have you an opinion as to the reasonableness of the amount of the credit to Thor's reserve for excess inventory at the end of 1964?

A. Yes. On the basis of the Arthur Andersen exhibit, which was performed in 1970, it is my opinion that the reserve used at the end of '64 was a reasonable reserve, possibly resulting in a reserve less than required—can I go on into one of the next exhibits?

Q. Certainly.

A. Because Exhibit 19 indicates that the reserve [326] at 1970 was understated by approximately 17 per cent. This would be consistent with the decreasing sales trend indicated on Exhibit 20. The inadequate reserve, the understatement by $36,000 is consistent with the decreasing sales trend, and since the formula was based on past usage in 1964, it would indicate that there was probably some understatement in that reserve at the end of '64 which followed its way through to 1970.

Q. Would you explain why the declining sales trend leads you to that conclusion?

A. Because a usage formula is based on the preceding year's usage. In a period of decreasing volume, the actual usage incurred in the subsequent year will be less than the estimate which is based on the preceding year's higher volume.

Q. Now, Mr. Burris, will you direct your attention, please, to Petitioner's Exhibit 22, which is captioned "Reserve For Excess and Obsolete Inventory."

On the basis of your review of that exhibit, have you come to any conclusion as to the reasonableness of Thor's reserve for excess inventory and the credit thereto in 1964?

A. Yes. On the basis of 1965 through 1971 [327] dispositions and additional provisions, it is my opinion that the reserve at the end of 1964 was a reasonable reserve because of the need for additional provisions in each of the subsequent years, coupled with the fact that the dispositions in those subsequent years, although less than the provisions to the reserve in total through 1964, there were several factors entering into that lag.

Number one, the fact that there probably was dispositions that were unrecognized. In any manufacturing operation, you are going to dispose of obsolete inventory, excess quantities, throw away stuff which is not recorded. You only record that which you see, not which gets wasted. Coupled with the fact that I would assume that at the end of any given point in time there will still be inventory on hand that will be thrown away at a later period, all of these causing the dispositions to be less than the provisions, but the dispositions in relation to the provisions in each of those years indicate that the reserve established at the end of '64 was a reasonable reserve.

Q. Now, Mr. Burris, would you direct your attention to Petitioner's Exhibit 17, which is captioned "Analysis of Depositions at Aurora and Los Angeles."

[328] Assuming, Mr. Burris, that the dispositions shown on Petitioner's Exhibit 17 relate entirely to excess items, have you an opinion on the basis of this exhibit as to the reasonableness of the credit to Thor's reserve for excess inventory at the end of 1964?

A. Yes. The total inventory reserve at the end of '64 was $1,079,000, of which 846,000 was attributable to Los Angeles, Aurora and branches.

Now, I understand that through 1971, $657,000 was the amount of dispositions at Los Angeles and Aurora, which is 78 per cent of the total related reserve of 846 on those items.

That would indicate to me, based on the fact that 78 per cent was disposed of, the items that I mentioned before, that a certain portion of dispositions of inventory is usually not recorded, and assuming that a portion of that inventory reserve in '64 may even still rest in certain plants, it would appear to me that the '64 reserve of 1,079,000 is reasonable based on a 78 per cent disposition factor.

Q. Mr. Burris, I am directing your attention particularly to the fact that the 846 item referred to in the second line of the summary relates to Los Angeles, Aurora and branches, and that the [329] disposition of 657,000 in the third line relates only to Los Angeles and Aurora. What relationship does that have on the opinion that you just expressed?

A. It means that the 78 per cent would be a higher number, I can't evaluate how much higher without knowing how much of that inventory rested at branches, but knowing it would be greater than 78 per cent, it would re-enforce my opinion that the dispositions throughout the '64 through '71 with respect to the items in inventory in '64 was reasonable.

Q. And that the amount established at the end of '64 was also a reasonable amount?

A. Was a reasonable reserve.

Q. Now, Mr. Burris, would you direct your attention, please, to Paragraph 10 of the Stipulation of Facts, beginning at the bottom of Page 6 and continuing to the top of Page 7.

Now, this refers to the credit to the reserve for excess inventory which was based on estimates other than the formula described in Paragraph 9 of the Stipulation of Facts.

Would you also direct your attention to Petitioner's Exhibit 13, which tabulates the amounts of the credit to the reserve based on this additional [330] estimate.

Have you an opinion as to whether this additional write down of $160,000 computed not on the basis of the formula, but on another basis, was in accordance with the generally accepted accounting principles, even though Thor used a formula for the bulk of its inventory write down for excess?

A. Yes, the formula was a procedure used to arrive at a lower of cost or market concept. Based on Paragraph 10, the past usage records was inadequate and therefore this formula would not be appropriate.

The procedure used on this reserve would not in any way violate the concept of generally accepted accounting principles, it being a procedure, and it is a reasonable procedure in given circumstances. There is nothing wrong with using both a formula and a specific identification type of items at the same time.

Q. Under generally accepted accounting principles and terminology, is it appropriate to characterize Thor's manner of its accounting for inventory at the end of 1964 as lower of cost or market?

A. Yes.

Q. Do generally accepted accounting principles prohibit the use of certain types of inventory [331] reserves?

A. Not if they are inventory valuation reserves to arrive at a lower of cost or market concept, no.

Q. What kind of inventory reserves are prohibited by generally accepted accounting principles?

A. General contingency reserves, reserves unrelated to the facts and circumstances at a given point in time. A valuation reserve, such as we are discussing here, would not be prohibited by generally accepted accounting principles.

Q. By that, you mean the reserve that Thor used?

A. That is correct.

Q. Is there any substantive difference from the point of view of generally accepted accounting principles between establishing a reserve for excess inventory or merely writing that excess inventory off the books without the use of a reserve?

A. None at all for accounting purposes. As a matter of fact, when a formula method is used, it would probably be more appropriate to use a reserve as opposed to a specific write off because of the inability to identify an item by item basis.

Q. Do generally accepted accounting principles and terminology recognize a distinction between a change in accounting principles on the one hand and a [332] change in procedure?

A. A change in principle from an auditor's point of view would result in a statement that the company has changed from one generally accepted accounting principle to another.

A change in procedure would not necessarily warrant any comment at all.

Q. Would you describe the change from the cash receipts and disbursements basis to the accrual basis as a change in principle or a change in procedure?

A. That would be a change in principle from an unaccepted accounting principle to a generally accepted accounting principle.

Q. How about in the case of accounting for long-term contracts, a change from the percentage of completion basis to the completed contract basis of accounting?

A. That would also be a change in accounting principle.

Q. Would you describe as a change in principle or a change in procedure a change from LIFO to FIFO inventory evaluation or vice versa?

A. That would be a change in accounting principle.

Q. How about a change from accelerated [333] depreciation to straight line depreciation or vice versa?

A. That would be a change in accounting principle.

Q. How about a change in computing a bad debt reserve from an age of account basis to a percentage of sales basis?

A. That would be a procedural change.

Q. How about a change from computing depreciation on the basis of lives of individual items to computing it on the basis of lives of groups of items?

A. That would also be a procedural change.

Q. How about a change from computing inventory quantities by complete count to computing them on the basis of sampling techniques?

A. That would strictly be a procedural change.

Q. How about a change from allocating overhead on the basis of labor dollars to allocating it on the basis of machine hours?

A. Also a change in procedure, not a change in principle.

Q. Now, Mr. Burris, I direct your attention, please, to Paragraph 6 of the Stipulation of Facts.

Assuming that at the end of 1966—1963 the only computation of excess inventory by Thor was done [334] in the manner described in Paragraph 6(a) of the Stipulation of Facts, and assume further that in 1964 Thor computed credits to its reserve for excess inventory in the manner described in Paragraphs 9 and 10 of the Stipulation of Facts, that is, by means of the formula and the special credit of $160,000 that we have described. In your opinion, does that represent or would that represent a change in accounting principle or a change in accounting procedure?

A. That would represent a change in procedure, not in principle. The accounting principle would be to value inventory at the lower of cost or market. The change to a formula method is a procedural change, not a change of principle.

Q. Now, assuming, Mr. Burris, that the management of a company concludes in a particular year that it has excess inventory, and assume that some of those items might actually have become excess in a prior year but had not been recognized as

such by management. What is the appropriate accounting treatment, in your opinion, in the year in which management concludes or determines that there is excess?

A. At the time that management determines there is excess inventory, that excess inventory should be recognized by a write down in inventory at that time.

[335] Q. On the basis of your review of the documents which you have referred to earlier in your testimony and your general experience, have you an opinion as to whether Thor's write down of its excess inventory as of December 31, 1964 was in accordance with generally accepted accounting principles?

A. Yes, it is my opinion that that write down was in accordance with generally accepted accounting principles.

Mr. Abrams: Your Honor, I have no further questions of this witness with respect to the inventory issue, but Mr. Berens does wish to examine him with respect to the bad debt issue.

The Court: Very well.

Direct Examination by Mr. Berens.

Q. Mr. Burris, I refer you to Petitioner's Exhibit No. 18, entitled "Analysis of Bad Debt Reserve Requirement as of December 31, 1965," and ask if you are familiar with that document.

A. Yes.

Q. Would you describe, based on what is contained in that document, your understanding of what the Petitioner did in evaluating its bad debt reserve that year?

[336] A. The Petitioner analyzed its accounts receivable by type and age of accounts, such as inter-company accounts, wherein no reserve was provided, and then other accounts. A reserve was provided based on a specific identification of certain accounts termed "hard core" of 100 per cent and reserves varying between 1 and 2 per cent was provided on the balance of the accounts based on an aging of those accounts receivable at December 31.

Q. On the [face] of it, does the method used by the Petitioner seem to be consistent with generally accepted accounting principles?

A. Yes, it is a very common method.

Q. Again, does it seem to be on the face of it a realistic practice, procedure?

A. Yes, the procedure of identifying specific accounts and then using a percentage based on an aging is a very common method of applying a reserve.

Q. If that method actually used by the Petitioner compared with a six-year moving average of its actual experience in its bad debt charge offs, do you have an opinion as to which method would be more likely to give a fair and more accurate result?

A. Well, it is my opinion that the more current information would recognize more current happenings. [337] The five or six year moving average would disclose what has happened historically, but would not be a complete barometer of the condition of the accounts at a given point in time.

At December 31, 1965 I would much prefer to see an aging of the accounts at that time rather than the historical write off experience.

Q. If conditions have changed over the six year period, is it possible that the mechanical averaging formula could yield an inaccurate result that might require a qualified opinion if it were material?

A. Yes, especially if the condition changed in the last year because of the weighting of the earlier years would have greater weight the later the conditions changed.

Q. Does a reserve of 100 per cent of certain specifically identified hard core accounts present any difficulties to you in evaluating the procedure used by a client?

A. No, not if the accounts are recognized as being remote of collection or no chance of collection at all. It merely indicates a valuation of no possibility of collection.

Q. Could a substantial increase in the so-called hard core accounts be a sort of change of events that [338] would make an averaging method over six years inaccurate?

A. Yes.

Mr. Berens: No further questions.

Mr. Sherman: I have no questions, Your Honor.

The Court: Thank you. You are excused, Mr. Burris.

* * *

[340] Mr. Berens: Mr. Weston, would you take the stand, please?

(The witness was duly sworn.)

FRANK T. WESTON, was called as a witness on behalf of the Petitioner, and, having been first duly sworn, testified as follows:

The Clerk: Be seated, please, sir. State your name and address for the record.

The Witness: My name is Frank T. Weston, W-e-s-t-o-n, 19 Timberline Road, Hohokus, New Jersey.

Direct Examination by Mr. Berens.

Q. Would you state your profession, Mr. Weston?

A. Yes, I am a Certified Public Accountant, a member of the public accounting firm of Arthur Young & Company.

Q. How long have you been a Certified Public Accountant?

A. I received [my] CPA certificate in the State of New York in 1939, and I have been with Arthur Young & Company continuously since 1937.

Q. Would you outline generally your career with [341] Arthur Young & Company?

A. I started on the audit staff in the New York office of Arthur Young & Company, and progressed up through the ranks becoming a manager in due course.

I was transferred to Boston in 1947 as Manager in charge of our Boston office. I was admitted as a partner to the firm in 1950, and returned to Boston—returned from Boston to New York in 1954. At that time I entered the home office of Arthur Young & Company, and was in charge of the SEC and Research Department.

I subsequently became Assistant National Director of Accounting and Auditing Standards, and in 1963 became the National Director for the Accounting and Auditing Standards.

I now hold the post of Chairman of our firm's Committee on Accounting and Auditing Standards.

Q. When you referred to the—being the National Director of Accounting and Auditing Standards, you mean of Arthur Young & Company.

A. Yes.

Q. When you were engaged in audit work, did this experience include that of manufacturing companies generally?

A. Yes. My audit experience covered various [342] types of industries, including manufacturing companies.

Q. Would you describe your role as National Director of Accounting and Auditing Standards and as Chairman of the Committee on Accounting and Auditing Standards in terms of your work in the firm?

A. Our firm has a home office organization consisting of probably 20 to 30 partners who are involved in setting policies, disseminating policies, passing on major accounting and auditing problems, preparing manuals and handbooks of instructional nature for our various offices and staffs around the country and around the world, and generally responsible for the determination of firmwide policy involved in representing the firm in matters where that is appropriate.

Q. Approximately how many professional accountants are partners or Managers or employees of Arthur Young & Company?

A. Well, this October 1st we will have approximately 400 general partners, and our total personnel will probably be in the neighborhood of 4,000 in this country.

Q. Would you outline your membership of various committees of the American Institute of Certified Public Accountants?

[343] A. I have been active in various professional organizations, both in the Massachusetts C. P. A. Society and in the New York Society. However, most of my effort has been involved in the National Society, the American Institute of Certified Public Accountants.

I have been a member, and for some years Chairman, of the Committee on Relations with the Securities and Exchange Commission and the stock exchanges, and I have recently completed a seven-year term on the Accounting Principles Board running from October, 1964 until December 31, 1971.

I am presently a member of a study group of the National Organization charged with establishing the objectives of financial accounting, a nine-man study group.

Q. Would you describe the function of this study group in a little more detail?

A. Well, as you know, there has been some discussion or some criticism of accounting in recent years primarily leveled at the charge that accounting is not responsive to the needs of users of financial statements; that our present accounting conventions are not responsive to economic reality; that balance sheets don't really show the net resources of companies, criticisms along those lines.

[344] In addition, there are some contrary criticisms that accounting does not show the cash flow activities of corporations or the liquidity of corporations which became rather important in recent years when liquidity became a problem.

So our charge basically is to review the present systems and conventions and principles of accounting, and to try to define objectives which will make accounting more useful in the future to users of statements.

Q. Would you state in general terms, Mr. Weston, the purposes of inventory accounting with respect to balance sheet presentation?

A. Well, the general objective of inventory accounting as is the case with most assets, is to establish amounts to be carried forward in a balance sheet which will enable the corporation to report its financial position at a year end, and the results of its operations for usually a 12-month period ended that date.

The accounting objectives are to take, if you will, the activities of a corporation over its entire life, which may run, as we know, in perpetuity, and to break that down into annual segments in such a way that management and investors and creditors and [345] governmental agencies will have some measure of the activities of that corporation in its economic efforts.

Therefore, we have developed conventions in accounting whereby assets are carried forward from one period to the next; that is, from the period in which they are acquired to some future period in which they will be used or generate revenue for the corporation.

So then we establish valuation or costing techniques which result in carrying inventories and other items in the balance sheet at amounts which purport to reflect the utility of those items.

In the case of inventories, we have rather precise and detailed rules which say that the inventories shall be carried at their cost as long as that cost does not exceed their utility. In terms of utility, in our professional literature, that word is translated to mean net realizable value which, in turn, means the amount to be realized on sale less costs of disposition.

So we have established in the inventory area a conservative lower of cost or market approach so that the inventory values presumably show the reader the amount which will, in fact, be realized based upon best information available when those [346] financial statements are prepared.

The contra to that, to come back to your question as to the income statement, is that having measured the proper amount to be carried forward in the balance sheet for an inventory item, we then have, in fact, computed the proper amount to be charged to the interim periods between balance sheets, since the utility test, or the fair value, or the realization test at each balance sheet must then automatically charge or credit to the income statement between balance sheets the appropriate amount so that each period then bears its proper share of costs of the activities of the company, and the reflection of value changes on inventories at least on the downward side.

That is basically a conservative approach to inventory valuation which is reflected in the accounting conventions.

* * *

Q. You spoke, Mr. Weston, of valuing inventory basically at cost unless its net realizable value is lower, at which time it has to be adjusted downward [347] accordingly.

Could you give me some examples of situations where it is necessary to reduce inventory to a lower net realizable figure?

A. Well, the circumstances requiring a reduction to net realizable value are, of course, quite different and depend on the circumstances of the industry involved. Certainly a question of obsolete inventory would raise questions as to the necessity for a write down to market. If new models are coming in and the company has a supply of parts or models or equipment or trucks or airplanes, any inventory item basically whose utility is indicated to be decreased because it has been superseded in the marketplace by a more efficient, a more productive item, certainly that requires an inventory adjustment.

Other similar reasons for adjustments would be damage to goods on shelves, handling, damage of that sort.

A decline in market entirely apart from the obsolescence factor, that is, a general downturn in prices particularly involving raw materials or products made from raw materials where a basic raw material price declines considerably. And then we also have a situation where for one reason or another, a company [348] may have more quantities of an inventory on hand than it can reasonably expect to sell, and that under the conservative approach of net realizable evaluation which guides inventory accounting it would also require an adjustment of inventory.

Q. Could, in the last category that you mentioned of excess inventory, could you give some illustrations where an excess inventory situation is created?

A. Well, we have some examples in recent years in the small airplane industry where the demands are moving from the propeller-driven planes to jet aircraft. This would be in the executive area. And also in certain cases in the commercial area where planes which have been produced for a market have suddenly become unsaleable because the market has changed and has accepted a more advanced technological product.

Other cases involve generally product model lines of business, lines of product, particularly with companies who have warranty or continuing service requirements where again a change in consumer tastes or competitive disadvantage has caused a corporation's product to become, in effect, not saleable at the basis at which it is carried.

[349] Q. Does this type of situation occur commonly where a company has a substantial service—after market service business?

A. Yes. This is an area which is often troublesome because of the commitments of such companies to service the product, and obviously the—their service reputation has a great deal to do with the ability to sell such items.

So most corporations in that type of business do carry a fairly good inventory in terms of quantities and diversified parts for most of their models, and they have a problem of carrying those inventories that come before them as the years go by.

Q. If such a situation exists for the inventory, that it is excess, whether it is spare service parts or otherwise, do generally accepted accounting principles require that this inventory be written down to net realizable value?

A. Yes. I would say there is no doubt that the fair value, the net realizable value test, and the utility test, which are all wrapped up into our cost or market whichever is lower theory, would require that excess inventories be reduced in carrying value under those circumstances.

Q. Are there any exceptions under generally [350] accepted accounting principles to this proposition you just stated?

A. No. There would be no exceptions in the general area that you stipulate. The only conceivable exception might be someone who had a price protected contract; that is, where there is a service contract with a stated price. Those are quite rare, and there it would be clear that the net realizable value would be as stated in the service contract.

Q. If your firm were auditing a client who had, in fact, excess inventory but was disinclined to write it down to net realizable value, what would you do?

A. Well, we would try very hard, of course, to convince the client that a write down, a reevaluation of the inventory in the balance sheet was essential, and failing in that, we would be inclined to say—in fact, we would say that we would not be in a position to give that client a clean opinion or an unqualified opinion; that is, we would take exception to carrying the inventory without some downward revaluation.

Q. Is it essential that the item be scrapped in order to write it down as excess to net realizable value?

[351] A. No. The physical scrapping of inventory is not an integral part of the valuation process. It may still be on hand and often is carried on hand.

Q. In the event that ending inventory were overstated because of the existence of excess quantities that were not valued downward to net realizable value, what would the effect of this be on the income for the current year and on the income for future periods?

Mr. Sherman: I will object to the question unless clarification is made as to what is meant here by "income." Income in the financial statement—

Mr. Berens: Yes. Income as reported income for generally accepted financial statements.

Mr. Sherman: No objection.

The Court: Very well.

By the Witness:

A. A determination that at December 31 of a given year an inventory contains excess inventory which was, as you stipulate, not reduced to its net realizable value, would result, in fact, in an overstatement of income for that year.

As to future years, presumably the inventory, if it were sold or scrapped at a price less than its carrying value, that loss would appear in some future [352] period's income statement, and under generally accepted accounting principles, that result would be improper; that is, the charge, the revaluation of the inventory, the write down to net realizable value, should be made in the year during which the nature or the excess was determined or existed.

By Mr. Berens:

Q. Could your—would you agree that your last statement could be paraphrased that the failure to write inventory down to net realizable value is to anticipate income between years?

A. Well, I am not sure I used the word "anticipate." I would say that it results in an improper shifting of the income between years. It should be—the charges should be made in the first year rather than in some subsequent year.

Q. From the viewpoint of generally accepted accounting principles, if a company is on the lower of cost or market inventory valuation, and it has excess inventory which is written down, is there any difference in theory justifying that write down between it being written down as an adjustment to market or being written down as a special type of obsolescence recognition?

A. No. From the point of view of generally [353] accepted accounting principles, the purpose, of course, is to carry the

inventory at the lower of cost or market, or the lower of cost or net realizable value, and the various elements or reasons which might cause a company to make such an adjustment are not differentiated from an accounting sense.

In other words, the nature of the item, the nature of—the reason why the adjustment is made, does not affect the necessity for the write down or its treatment in the account.

Q. In your experience, are there circumstances where the use of a formula can properly be used for evaluating excess inventory, and by "formula," I mean one based on usage or expected usage?

A. Yes. It is not uncommon in situations involving complex activity, or a great number of inventory items, to resort to a use of a formula as a convenient way of determining an amount of an overall adjustment to reflect net realizable value.

Q. And if this formula under the facts and circumstances is reasonable, it is in accord—is it in accord with generally accepted accounting principles?

A. Well, the results obtained by use of the formula, which is the write down to market, is what [354] generally accepted accounting principles require.

The formula is an appropriate method of arriving at that answer.

Q. And in your experience, is the use of such formulas for this purpose commonplace, or unusual?

A. I would say in the case of corporations with significantly large inventories, particularly service parts and parts involved in guarantees and warrantys, that it is not uncommon to use such an approach in determining net realizable value.

Q. Mr. Weston, have you—have you had an opportunity to read the statutory notice of deficiency in this case?

A. Yes.

Q. And the Petition filed by the taxpayer in this case?

A. Yes.

Q. And the Answer by the Government?

A. Yes.

Q. And the Stipulation of Facts—

A. Yes.

Q. —between the parties? And certain exhibits, particularly Exhibit Nos. 13 to 17, 19 and 20, and 22 through 27?

A. Yes.

[355] Q. Based on your review of these items, in your opinion was Thor obligated to write down any excess inventory it might have had in 1964?

A. Assuming that the determination of the excess quantities followed the stated formula, it would be my opinion that a write down to net realizable value was required under generally accepted accounting principles in 1964.

Q. And if you had been Thor's auditor at that time, and based on the premise you just stated, and Thor had refused to write down its inventory as indicated, would you have been able to give an unqualified opinion as to its financial statement?

A. No. In my opinion, our firm would not have given an unqualified opinion had such an adjustment not been made.

Q. I refer you to Paragraph—Paragraph 8 of the Stipulation, and particularly 8(b) referring to the number of parts in Thor's inventory at the end of 1964.

Based on that, I ask you whether it was appropriate or necessary for Thor to use a formula such as it did to value its excess inventory?

A. I would say, based on an inventory of that size, that is, with over 40,000 individual items, [356] that the use of some type of formula would be almost essential, and the purpose, of course, would be to save time, but still get some sort of a reasonable and practical answer under the circumstances.

This occurs quite often in accounting, where we have to balance the cost of doing a very detailed determination of some audit step; for example, looking at vouchers or checking inventories, or items of that nature, involving thousands of items. The cost to do a 100 per cent job in any of those areas is

prohibitive. So we do have some general ground rules, standards, whereby reasonable approaches to handling significant items, where the quantities involved are large, and they would be here, where techniques have been involved which are perfectly proper and acceptable.

Q. Did the particular formula used by Thor appear, in your opinion, to fall within these parameters you have just outlined?

A. Yes. Based on the material that I have reviewed, it seems to me that was a reasonable approach to this situation.

Q. And does your conclusion in that respect appertain also to the fact that it is basically estimated on future use by past years' actual use?

[357] A. Well, this is a difficult question in establishing a reserve of this sort. As in many areas of accounting, we are attempting to estimate future activities, future developments, and as in other areas, we find the various bits of evidence. Certainly, one of the most important bits of evidence in this area would be the actual sales for the current year. Add to that knowledge of management as to estimated changes in sales in the forthcoming periods, knowledge of industry, statistics of general economic conditions. There are a number of things which enter into such a determination, but certainly the usage or sales for the last year would be a good starting point.

Q. I refer you to Paragraph—I refer you to Paragraph 10 of the Stipulation and Exhibit—and Exhibit 13, which together outline the additional provision made by Thor in 1964 for excess inventory in the amount of roughly $160,000 which was supplementary to the formula approach, and ask you whether, in your opinion, a formula approach can be combined with a specifically additional charge such as this was?

A. As I understand the so-called "special reserve" to which you refer, this covered items or [358] areas of the inventory in which sufficient data was not available to follow the formula approach, and as I understand it, management undertook to make estimates of the amount of excess inventory based on their experience and understanding.

This is certainly a reasonable—a reasonable approach to a problem of this sort where data is not available. There would, of course, be a problem for the auditor in satisfying himself as to the basis on which management makes such a determination, and that would be a separate problem for the auditor.

However, there is no basic reason why a subjective evaluation of obsolescence of that sort made in good faith and based on whatever records are available should be considered to be in conflict in a realistic sense with the use of a formula with respect to the balance of the excess inventory.

Q. I refer you to exhibits previously mentioned, and in particular Exhibit No. 20—20 is the number I am trying to find—and ask you whether this—this material contained in that document leads you to any opinion regarding the validity of the provision made by Thor in 1964.

A. Well, it is difficult to express an opinion as to the adequacy of a reserve, based on a series of [359] income statements as appear on Exhibit 20.

However, as I understand the technique of the company, it did perform a formula computation at the end of every year, based on the same formula used in 1964. I do observe that net sales of this company decreased almost without exception every year which appears on Exhibit 20, and under those conditions, based on a formula which is based on current usage, I would expect that the reserve might well be less than would have been determined based on complete hindsight.

This is borne out in general by the figures at the bottom of Exhibit 20 indicating that the reserve increased in the years '65 and '67 significantly, and fluctuated in other years.

Q. Do I understand you correctly to indicate that the—so far as you can form a conclusion, the indication was that the '64 reserve may have been too little for excess inventory?

A. Well, my conclusion would be based on the decline in sales and the adjustment of the reserve; that it certainly was not overstated, and I would be inclined to, therefore, conclude that it might have been understated.

Q. All right. I refer you to Petitioner's [360] Exhibit No. 17, entitled "Analysis of Dispositions," and ask you if you are familiar with that.

A. Yes.

Q. Would you state any conclusions that you derived from this particular document?

A. As I understand Exhibit 17, this is an analysis of the dispositions by scrapping of individual items which were carried in the 1964 inventory and identified in the general nature of excess inventory.

The schedule then purports to show the dispositions of those items down through 1971, at Aurora and Los Angeles.

It then compares the total reserve at December 31, '64, in the amounts attributable to Los Angeles, Aurora, and some branches. It then shows the dispositions at Los Angeles and Aurora.

I understand there are some 20-odd branches involved, and the exhibit does not disclose the amount of the reserve attributable to the branches. However, it does indicate that dispositions to date have accounted for nearly 78 per cent of the related reserve provisions for Los Angeles, Aurora, and the branches, which would tend to imply or infer that the—if the branches had been included in the [361] disposition figures, the reserve requirements would have been higher than the 78 per cent shown.

So my conclusions, based on this analysis through '71, would be that the figure is—the figure in the reserve for Los Angeles and Aurora is within reasonable—a reasonable figure of—an appropriate figure, and that it may well be higher than the 78 per cent shown there.

In other words, the test basically of the workout of the inventory at '64 indicates that the reserve was within reasonable limits, based on these somewhat inconclusive data in terms of the branches.

Q. In your opinion, Mr. Weston, did Thor evaluate its inventory at the end of 1964 on the method known as the lower of cost or market?

A. Yes. Based on the information I have reviewed, I would say that the techniques involved were in accordance with the accounting approach for determining the lower of cost or market for this particular inventory.

Q. When you say "the accounting approach," you mean the approach that fulfills the requirements of generally accepted accounting principles?

A. Yes. Generally accepted accounting [362] principles, the lower of cost or market requirement.

Q. From an accounting viewpoint, was the fact that—or does the fact that Thor has charged these write downs to an inventory reserve account have any difference than if it had made direct write offs or write downs in the inventory for the excess inventory?

A. No. The use of a reserve valuation account, as in this case, is often done in order to avoid the detailed complications of attempting to trace each item as it moves during the year.

In fact, with a complex operation involving a number of locations, it is almost always handled through an inventory valuation account rather than a direct write down. It is just easier to keep track of things by running it through a separate inventory valuation account in terms of the balance sheets and income statements.

However, there is no substantive difference in the end result or the purpose of the accounting.

Q. On the basis of your review of the facts in evidence, is it—do you have an opinion whether Thor's write down of its inventories for excess as of December 31, 1964, was in accordance with generally accepted accounting principles?

A. In order to have an opinion as to the [363] appropriateness of the write down itself, that is, the amount of the write down, it would be necessary for me to be generally satisfied as

to the validity of the basis for the formula. That is, I would have to know more about the circumstances of the company at that particular time, the estimated sales, the condition of the industry, competitive forces, and so on, and those all enter into the determination of the formula.

But based on what I have seen, the approach used was certainly in accordance with generally accepted accounting principles, and one which I and my firm would endorse.

Mr. Berens: Off the record for a moment, Your Honor.

(Whereupon, a discussion was had off the record.)

Mr. Berens: No further questions on direct.

Cross Examination by Mr. Sherman.

Q. Mr. Weston, did I understand you to testify that where it is determined that there is excess inventory being carried on the books, that this excess should be written down in the year in which the excess is determined?

[364] A. I said in the year determined. In most cases that would also be the year in which the excess was created or first existed, if you will. In other words, I didn't mean to imply that a corporation could disregard excess inventories, and then finally in one year determine that there was excess. I was implying that a determination or a review would be made each year, and in that sense I used the determination as being the year in which it, in fact, first existed. I didn't mean to imply that you could defer making a determination.

Q. Well, if, in fact, the excess was not created in the particular year involved, but had existed in a prior year, what would the treatment of such excess be on the basis of generally accepted accounting principles in the year—

A. In which year?

Q. In the year in which this excess was determined or discovered, although it was subsequent to the year in which it was created.

A. You mean in Year One, there was, in fact, an excess?

Q. That is correct.

A. But it was not recognized or recorded as such for accounting purposes?

[365] That is correct.

A. In Year Two there was a determination made that there was an excess which was overlooked in Year One?

Q. Either overlooked or—or intentionally not written down. Take either of those situations. If your answer would be different in one case as opposed to the other, then give me the answer to each of those two different possibilities.

A. Well, we are in a rather complex area in which the accounting results are somewhat complex. If the management, and this has to do with estimation of inventories—I mentioned earlier estimates of inventories, accounts receivable, the nature of items where a determination of values are imprecise and based on estimates and so on, if we assume at the end of Year One that management in good faith had made an estimate or a determination of excess and obsolescence, then under our accounting rules that determination stands, made in good faith, and any subsequent adjustments of those estimates fall when the adjustments are determined or come to light.

Now, the crunch part of your question is: Was an estimate as to excess inventories made in good faith at the end of Year One, and I will ask you [366] to clarify the question on that point.

Q. Well, let us assume that there was excess inventory in Year One, and that it was not—it was not discovered. But upon subsequent discovery in Year Two, it becomes apparent that the same condition did exist in Year One.

A. Well, we have some accounting literature that describes that as a correction of an error, the omission of information, the misuse of information. But assuming that any one of those three might have occurred, then our generally accepted accounting rules say, and this is contained in Opinion No. 20 of the

Accounting Principles Board, which was issued fairly recently, that opinion states that correction of an error should, in fact, be rolled back to the year in which the—in your case—the excess inventory did, in fact, occur.

Mr. Sherman: No further questions.

Redirect Examination by Mr. Berens.

Q. Taking up Counsel's hypothetical, if that was not an error but a mistake in estimate, what would the accounting treatment be?

A. That implies or infers that management did make a determination and present—presumably their [367] auditors reviewed it. If there is no evidence that that was an error, a misuse of information, that it was in good faith and determined it was a bona fide estimate based upon the best knowledge available, then any subsequent difference or any change in the determination of excess inventories falls in the subsequent periods as a part of this general theory that we are always estimating things every time we close the accounts, and we can't continually go back and change prior figures as long as the original estimates are made to determine fair value on a reasonable basis.

Q. Then in his example, that would belong to Year Two if it were a correction of an honest estimate?

A. Yes. If a bona fide estimate were made at the end of Year One, then any subsequent adjustments in a sense become a Year Two charge.

Q. In the practice of accounting, are there any practical presumptions that the independent auditor gives to management in evaluating whether the earlier year—earlier year's estimate was an error or just a mistake in estimate?

A. Well, this depends in part, of course, on whether the auditor was, in fact, the auditor at [368] end of Year One. If he were at that time the auditor, he would be on the scene, and would be, through his auditing procedures, determining whether appropriate consideration was being given to such questions as excess inventories. He is on the scene at that time

and makes up his mind at the time the accounts for Year One are closed.

So in terms of his own position, and management's, the management makes the first determination. He then reviews that, and assuming as I gather you do, that he is then satisfied with that determination, then he would not raise a question subsequently that a revision in the estimate made in good faith would require any adjustment of the prior period.

Q. And if in the first year, as to the excess inventory, the auditor had given an unqualified opinion, would he be more or less required the second year to accept that as a change in estimate and belonging to that particular year?

A. Well, the assumption that he gave a qualified opinion that—

Q. I said "unqualified."

A. (Continuing) unqualified opinion assumes that he was satisfied with respect to the inventory [369] valuation, and assumes the amounts were material in the absence of some evidence of error or purpose from this statement, he would not be inclined to ask management to change those earlier figures.

Q. You used the words "would not be inclined"—

A. Well, that's probably a professional over-simplification. He would probably resist any change absent evidence of that —that there was an error or a direct misstatement, based on the facts available.

Q. You say he would resist any change? He would attribute that, then, to the second—to the year number two?

A. Yes.

Q. Now, you refer—you have qualified each time that unless there was an error and/or misstatement; to what degree would he require that error to be evident as a practical matter?

A. Well, I am not sure that there are degrees of satisfaction as to whether an error exists or not. He would examine the evidence as to the possibilities of error, and would form his opinion

as to whether this difference was, in fact, an error, or was a difference in opinion, or an error in judgment in that sense. [370] That is very difficult to describe the gradations of judgment involved in determining whether something is in error or a managemental—a management mistake, let's say.

Q. Well—

A. An error in estimate is what I mean.

Q. Perhaps I can phrase the question this way: If he had given an unqualified opinion the first year, as a matter of practice would he be inclined to give management the benefit of the doubt as to what year the excess arose?

A. Well, in the first case, having examined the financial statements at the end of Year One, he was, in fact, satisfied that the inventory was properly stated and presumably followed auditing procedures with respect to inventory, so that from his professional opinion it was clear that he was satisfied the inventories were properly stated at the lower of cost or market.

Now, if something occurred in a subsequent year which would raise questions as to the validity of that determination of inventories at the end of Year One, he would assess those circumstances and attempt to determine whether there was, in fact, a change in circumstance, a reasonable development [371] which indicated the original estimates were not proper in terms of estimates or, in fact, a mechanical error such as someone dropping an inventory page on the floor and not binding it into the final inventory, or a definite intentional misstatement. It would be unlikely, in my view, that either of the latter two would occur to a material degree in a balance sheet certified to by a large accounting firm, and that is why I say there would be less—in my view, at least, less indication or inclination, which was the word I used, to consider a possibility of an error, although I wouldn't rule it out completely.

Mr. Berens: All right. No further questions on redirect.

The Court: Mr. Sherman?

Mr. Sherman: No further questions, Your Honor.

The Court: I have a couple of questions I would like to ask.

Examination by the Court.

Q. Let's say you are performing an audit on a corporation and you find an adjustment at the ending inventory for excess inventory. Do you have any standards, or do you have any guidelines as to how [372] large that adjustment would have to be in relation, say, to gross income or sales, or other items going into the company's expense statement which would cause you to inquire as to the inventory procedures for the beginning of that year, or let's say the inventory procedures for the end of the preceding year?

A. You have changed the question at the very end. I thought you were talking about the materiality of that item with respect to the closing inventory, but you are stipulating a discovery of a fact or a condition in connection with the year-end inventory which might raise questions as to whether those conditions existed at the beginning of the year.

Q. Well, I am getting at this: Let's say you find a large adjustment at the end of the year, a write down by reason of excess inventory. Now, do you have any guidelines as to how large that write down must be before you will inquire into the inventory procedures for the end of the preceding year in order to determine whether part of that—that write down should have been in the previous year?

A. Well, it would be my view that any inventory adjustment which is based on an indication of excess, slow moving, obsolete or damaged inventory, which is of such size that—well, we use the term [373] "material" in accounting—that it is material enough to cause the auditor to question the inventory accounting and production control procedures of the company would, in fact, give rise to this question as to whether a similar condition existed at the beginning of the year.

Now, as I indicated earlier, the question is somewhat complicated by an assumption as to whether the same auditor made the examination at the beginning of the year. If he were there at the

beginning of this year, or the end of Year One, as we were using in the example, then he presumably went through these inventory evaluation procedures.

Having done that, and done it well, then at the end of the year he really should be in for no surprises, and I would be surprised if, for example, he suddenly determined that the company had a stock of spare parts for an automobile which was equal to six years' sales. It would be hard to believe, particularly if that were an older model, that those were all produced during this year.

And then I am sure he would say, "Well, what about last year? What was the status of those items last year?"

So he would certainly, if he were auditing [374] this company for the first time, and other auditors had been involved in the previous year, this would be a very serious question, and there are some cases in which there are disagreements, in fact, as to when obsolescence or excess conditions or obsolete or damaged merchandise, when that, in fact occurred. It is not uncommon involving large companies occasionally.

But, assuming that the same auditor were there at each year-end, then as I say, he would not expect to have—in terms of how large this adjustment should be, that is difficult to state. Inventories, as you can appreciate, are basically broken down by locations. They are broken down by categories. The difference between one location this year and next might be significant for that location, but not in total.

So as in many areas of accounting, we don't have any materiality guideline, and we have been criticized for not having it. But there isn't any rule of thumb that you can say if the inventory adjustment is more than 10 per cent of this year, that is a red flag and then you should go back to last year.

I would think if it were more than ten years and it involved an indication that the inventory [375] at the end of Year Two were, in fact, excess and of the type I mentioned, more than three or four years' supply on an item which was really becoming obsolete or becoming a second-rate product, then the auditor just has to go back and look, even if he did the audit.

I think in good faith, you do.

The Court: Does this raise any questions that either of you wish to inquire about further?

Mr. Berens: No, Your Honor.

The Court: Very well. Thank you, Mr. Weston. You are excused.

(Witness excused.)

Mr. Berens: The Petitioner rests, Your Honor.

The Court: Thank you.

Thereupon the Petitioner rested his case in chief.

Mr. Sherman: The Respondent rests, Your Honor.

The Court: Very well.

Thereupon the Respondent rested his case in chief.

* * *

[384] Mr. Berens: Your Honor, Counsel and I discussed the possibility of seeing if during the briefing period we could stipulate to the so-called year that the excess arose, should that become relevant. They said on some of the expert testimony, it may not be relevant at all.

If our efforts are going to be stipulated to, Counsel has a very high work load, and I would like to—and he may be hard pressed to do it; we seem to have more people available. I don't want to get him in a position where we are claiming we would and he wouldn't. You may have the whole case before you before you decide it.

Mr. Sherman: I would point out, though, that I think an aspect of the case also is to show— [385] Petitioner has this theory with respect to how much of the inventory as of the end of 1964 was in the inventory at various periods, or how much of it became excess at various prior periods.

I think it would be also relevant to show for this same purpose—I don't believe that the Court couldn't decide this case fully without it. If it decided for the Petitioner on the basic question of use of this method and the change of the accounting, I think it would also be necessary to show the effect that the

application of the same procedures would have had at the beginning of the year, and I have already had the revenue agent who is now assigned to the case who, incidentally, is neither of the agents who had previously been involved with the case—they are both retired now—I have asked him to contact Mr. Allen and—so the matter of expediting this is in his hands, and I have done as much as I can towards getting this information obtained and stipulated to as soon as we possibly can.

The Court: Well, the Court appreciates any efforts you can make to stipulate to it, because you say you have adequate personnel right now, but the Court is kind of short of personnel right now. We have two vacancies on the Court, so anything you [386] can do to make it unnecessary to have a further trial in the case will be greatly appreciated.

* * *

Petitioner's Exhibit 13

THOR POWER TOOL DIVISION & C.R.M.Co.

SPECIAL RESERVE FOR EXCESS INVENTORY VALUATION

December 31, 1964

	Description of Inventory	Gross Usable Inventory*/	Special Reserve: % of Usable Inv.	Special Reserve: Amount
Speedway				
	Raw Material	$ 90,767	10%	$ 9,077
	Tool Parts - Code 31	445,609	5	22,280
	Hardware - Code 33	69,075	50	34,537
	Motor Parts - Code 35	81,214	5	4,061
	Manuals & Nameplates Code 75	31,275	10	3,127
	Work-in-Process	487,505	10	48,750
		$1,205,455		$121,832
Cincinnati Rubber				
	Raw Material	$ 89,000	10	$ 9,000 **/
	Work-in-Process	126,000	10	13,000 **/
	Finished Goods	170,000	10	17,000
		$ 385,000		$ 39,000

*/ Meaning inventory exclusive of that referred to in the last paragraph of Joint Exhibit 7-G.

**/ Reserve provisions at Cincinnati Rubber rounded to nearest thousands.

Petitioner's Exhibit 14

THOR POWER TOOL COMPANY

SUMMARY OF INVENTORIES
AND
VALUATION RESERVES
AS OF DECEMBER 31, 1964

	Gross Usable Inventory */	Inventory Supply- Based on Prior Year's Usage				Valuation Reserves			% of Reserve	Net Usable Inventory
		1-12 Mos.	13-18 Mos.	19-24 Mos.	Over 24 Mos.	Based on Formula	Special	Total		
Thor Power Tool Division										
Raw Material	$ 531,202	$ 490,447	$ 12,577	$ 6,731	$ 21,447	$ 32,783	$ 9,077	$ 41,860	3.9	$ 489,342
Completed Parts & Accessories	4,508,601	3,692,020	186,748	86,646	543,187	701,547	64,005	765,552	70.9	3,743,049
Work-in-Process	1,478,927	1,454,152	8,955	5,590	10,230	18,900	48,750	67,650	6.3	1,411,277
Finished Goods, other than Parts & Accessories	1,821,210	1,617,249	68,818	26,620	108,523	162,898	-	162,898	15.1	1,658,312
Total	8,339,940	7,253,868	277,098	125,587	683,387	916,128	121,832	1,037,960	96.2	7,301,980
Cincinnati Rubber Division										
Raw Material	96,000	95,571	50	50	329	392	9,000	9,392	.9	86,608
Work-in-Process	126,000	126,000	-	-	-	-	13,000	13,000	1.2	113,000
Finished Goods	169,273	167,122	626	485	1,040	1,717	17,000	18,717	1.7	150,556
Total	391,273	388,693	676	535	1,369	2,109	39,000	41,109	3.8	350,164
Total Usable Inventory*/	$8,731,213	7,642,561	277,774	126,122	684,756					
Valuation Reserves										
Formula		-0-	50%	75%	100%					
Amount		$ -0-	$138,887	$ 94,594	$684,756	$918,237	$160,832	$1,079,069	100.0	
Net Usable Inventory										$7,652,144

*/ Meaning inventory exclusive of that referred to in the last paragraph of Joint Exhibit 7-G.

Prepared: May 19, 1972

Petitioner's Exhibit 15

THOR POWER TOOL COMPANY

SUMMARY OF INVENTORIES
AND
VALUATION RESERVES
AS OF DECEMBER 31, 1965

	Gross Usable Inventory *	Inventory Supply- Based on Prior Year's Usage 1-12 Mos.	13-18 Mos.	19-24 Mos.	Over 24 Mos.	Formula Valuation Reserve	% of Reserve	Net Usable Inventory
Thor Power Tool Division								
Raw Material	$ 489,263	$ 374,571	$ 2,234	$ 1,485	$ 110,973	$ 113,207	8.2	$ 376,056
Completed Parts and Accessories	4,027,841**	2,869,131**	155,866**	98,268**	904,576**	1,056,210**	76.1	2,971,631**
Work-in-Process	574,354**	487,454**	-	-	86,900**	86,900**	6.3	487,454**
Finished Goods, other than Parts and Accessories	1,862,995	1,707,970	55,306	33,853	65,866	118,909	8.5	1,744,086
Total	6,954,453	5,439,126	213,406	133,606	1,168,315	1,375,226	99.1	5,579,227
Cincinnati Rubber Division								
Raw Material	98,854	98,854	-	-	-	-	-	98,854
Work-in-Process	105,701	105,701	-	-	-	-	-	105,701
Finished Goods	149,728	137,176	-	-	12,552	12,552	.9	137,176
Total	354,283	341,731	-	-	12,552	12,552	.9	341,731
Total Usable Inventory *	$7,308,736	5,780,857	213,406	133,606	1,180,867			
Valuation Reserves								
Formula		-0-	50%	75%	100%			
Amount		$ -0-	$106,703	$100,208	$1,180,867	$1,387,778	100.0	
Net Usable Inventory								$5,920,958

* Meaning inventory exclusive of that referred to in the last paragraph of Joint Exhibit 7-G.

** Insufficient data are available to accurately separate inventories and reserves between "Completed Parts and Accessories" and Work-in-Process" for the years 1965 and 1966. The allocation of inventories and reserves between these two categories is based on average actual experience for 1967 through 1971.

Prepared May 19, 1972

Petitioner's Exhibit 16

THOR POWER TOOL COMPANY

SUMMARY OF INVENTORIES
AND
VALUATION RESERVES
AS OF DECEMBER 31, 1966

	Gross Usable Inventory *	Inventory Supply-Based on Prior Year's Usage				Formula Valuation Reserve	% of Reserve	Net Usable Inventory
		1-12 Mos.	13-18 Mos.	19-24 Mos.	Over 24 Mos.			
Thor Power Tool Division								
Raw Material	$ 470,000	$ 313,333	$ 60,000	$26,667	$ 70,000	$ 120,000	9.4	$ 350,000
Completed Parts and Accessories	4,532,988**	3,594,420**	67,666**	39,319**	831,583**	894,905**	69.7	3,638,083**
Work-in-Process	646,386**	548,588**	-	-	97,798**	97,798**	7.6	548,588**
Finished Goods, other than Parts and Accessories	2,240,420	2,055,691	86,894	30,873	66,962	133,564	10.4	2,106,856
Total	7,889,794	6,512,032	214,560	96,859	1,066,343	1,246,267	97.1	6,643,527
Cincinnati Rubber Division								
Raw Material	123,763	121,411	-	-	2,352	2,352	.2	121,411
Work-in-Process	106,017	105,910	-	-	107	107	-	105,910
Finished Goods	160,343	125,354	-	-	34,989	34,989	2.7	125,354
Total	390,123	352,675	-	-	37,448	37,448	2.9	352,675
Total Usable Inventory*	$8,279,917	6,864,707	214,560	96,859	1,103,791			
Valuation Reserves								
Formula		-0-	50%	75%	100%			
Amount		$ -0-	$107,280	$72,644	$1,103,791	$1,283,715	100.0	
Net Usable Inventory								$6,996,202

* Meaning inventory exclusive of that referred to in the last paragraph of Joint Exhibit 7-G.

** Insufficient data are available to accurately separate inventories and reserves between "Completed Parts and Accessories" and Work-in-process" for the years 1965 and 1966. The allocation of inventories and reserves between these two categories is based on average actual experience for 1967 through 1971.

Prepared: May 19, 1972

Petitioner's Exhibit 23

THOR POWER TOOL COMPANY

SUMMARY OF INVENTORIES
AND
VALUATION RESERVES
AS OF NOVEMBER 30, 1967

	Gross Usable Inventory*/	Inventory Supply- Based on Prior Year's Usage 1-12 Mos.	13-18 Mos.	19-24 Mos.	Over 24 Mos.	Formula Valuation Reserve	% of Reserve	Net Usable Inventory
Thor Power Tool Division								
Raw Material	$ 466,358	$ 374,039	$ -	$ -	$ 92,319	$ 92,319	4.7	$ 374,039
Completed Parts and Accessories	5,242,161	3,477,082	430,271	242,076	1,092,732	1,489,425	75.9	3,752,736
Work-in-Process	561,957	435,000	-	-	126,957	126,957	6.5	435,000
Finished Goods, other than Parts and Accessories	1,541,519	1,279,344	81,590	45,190	135,395	210,082	10.7	1,331,437
Total	7,811,995	5,565,465	511,861	287,266	1,447,403	1,918,783	97.8	5,893,212
Cincinnati Rubber Division								
Raw Material	127,173	124,997	-	-	2,176	2,176	.1	124,997
Work-in-Process	98,994	98,994	-	-	-	-		98,994
Finished Goods	146,984	105,396	-	-	41,588	41,588	2.1	105,396
Total	373,151	329,387	-	-	43,764	43,764	2.2	329,387
Total Usable Inventory */	$8,185,146	5,894,852	511,861	287,266	1,491,167			
Valuation Reserves								
Formula		-	50%	75%	100%			
Amount		$ -	$ 255,930	$ 215,450	$1,491,167	$1,962,547	100.0	
Net Usable Inventory								$6,222,599

*/ Meaning inventory exclusive of that referred to in the last paragraph of Joint Exhibit 7-G.

Prepared: June 20, 1972

Petitioner's Exhibit 24

THOR POWER TOOL COMPANY

SUMMARY OF INVENTORIES
AND
VALUATION RESERVES
AS OF NOVEMBER 30, 1968

	Gross Usable Inventory */	Inventory Supply- Based on Prior Year's Usage 1-12 Mos.	13-18 Mos.	19-24 Mos.	Over 24 Mos.	Formula Valuation Reserve	% of Reserve	Net Usable Inventory
Thor Power Tool Division								
Raw Material	$ 415,568	$ 339,505	$ -	$ -	$ 76,063	$ 76,063	3.8	$ 339,505
Completed Parts and Accessories	4,993,909	3,083,310	423,772	242,769	1,244,058	1,638,021	81.7	3,355,888
Work-in-Process	447,016	364,807	-	-	82,209	82,209	4.1	364,807
Finished Goods, other than Parts and Accessories	1,563,927	1,336,570	92,207	43,528	91,622	170,372	8.5	1,393,555
Total	7,420,420	5,124,192	515,979	286,297	1,493,952	1,966,665	98.1	5,453,755
Cincinnati Rubber Division								
Raw Material	128,062	128,062	-	-	-	-		128,062
Work-in-Process	108,810	108,810	-	-	-	-		108,810
Finished Goods	145,675	108,249	-	-	37,426	37,426	1.9	108,249
Total	382,547	345,121	-	-	37,426	37,426	1.9	345,121
Total Usable Inventory */	$7,802,967	5,469,313	515,979	286,297	1,531,378			
Valuation Reserves								
Formula		-	50%	75%	100%			
Amount		$ -	$ 257,990	$ 214,723	$1,531,378	$2,004,091	100.0	
Net Usable Inventory								$5,798,876

*/ Meaning inventory exclusive of that referred to in the last paragraph of Joint Exhibit 7-G.

Prepared: June 20, 1972

Petitioner's Exhibit 25

THOR POWER TOOL COMPANY

SUMMARY OF INVENTORIES
AND
VALUATION RESERVES
AS OF NOVEMBER 30, 1969

	Gross Usable Inventory*/	Inventory Supply- Based on Prior Year's Usage 1-12 Mos.	13-18 Mos.	19-24 Mos.	Over 24 Mos.	Formula Valuation Reserve	% of Reserve	Net Usable Inventory
Thor Power Tool Division								
Raw Material	$ 413,630	$ 366,764	$ -	$ -	$ 46,866	$ 46,866	3.4	$ 366,764
Completed Parts and Accessories	4,212,925	2,899,870	276,850	161,336	874,869	1,134,296	81.9	3,078,629
Work-in-Process	534,616	463,275	-	-	71,341	71,341	5.1	463,275
Finished Goods, other than Parts and Accessories	1,214,889	1,109,895	43,492	25,345	36,157	76,912	5.6	1,137,977
Total	6,376,060	4,839,804	320,342	186,681	1,029,233	1,329,415	96.0	5,046,645
Cincinnati Rubber Division								
Raw Material	172,823	170,413	-	-	2,410	2,410	.2	170,413
Work-in-Process	118,645	117,559	-	-	1,086	1,086	.1	117,559
Finished Goods	157,338	104,921	-	-	52,417	52,417	3.7	104,921
Total	448,806	392,893	-	-	55,913	55,913	4.0	392,893
Total Usable Inventory*/	$6,824,866	5,232,697	320,342	186,681	1,085,146			
Valuation Reserves								
Formula		-	50%	75%	100%			
Amount		$ -	$ 160,171	$ 140,011	$1,085,146	$1,385,328	100.0	
Net Usable Inventory								$5,439,538

*/ Meaning inventory exclusive of that referred to in the last paragraph of Joint Exhibit 7-G.

Prepared: June 20, 1972

THOR POWER TOOL COMPANY

SUMMARY OF INVENTORIES
AND
VALUATION RESERVES
AS OF NOVEMBER 30, 1970

	Gross Usable Inventory */	Inventory Supply- Based on Prior Year's Usage 1-12 Mos.	13-18 Mos.	19-24 Mos.	Over 24 Mos.	Valuation Reserves Based on Formula	Special**	Total	% of Reserve	Net Usable Inventory
Thor Power Tool Division										
Raw Material	$ 512,855	$ 396,451	$ -	$ -	$ 116,404	$ 116,404	$ -	$ 116,404	7.3	$ 396,451
Completed Parts and Accessories	3,953,889	2,489,476	374,839	252,359	837,215	1,213,904	-	1,213,904	76.1	2,739,985
Work-in-Process	749,025	595,928	38,023	47,392	67,682	122,237	-	122,237	7.7	626,788
Finished Goods, other than Parts and Accessories	1,533,787	1,411,472	56,918	12,067	53,330	90,839	6,802**	97,641	6.1	1,436,146
Total	6,749,556	4,893,327	469,780	311,818	1,074,631	1,543,384	6,802	1,550,186	97.2	5,199,370
Cincinnati Rubber Division										
Raw Material	126,629	125,664	-	-	965	965	-	965	.1	125,664
Work-in-Process	101,867	101,867	-	-	-	-	-	-		101,867
Finished Goods	105,922	61,876	-	-	44,046	44,046	-	44,046	2.7	61,876
Total	334,418	289,407	-	-	45,011	45,011	-	45,011	2.8	289,407
Total Usable Inventory */	$7,083,974	5,182,734	469,780	311,818	1,119,642					
Valuation Reserves										
Formula		-	50%	75%	100%					
Amount		$ -	$ 234,890	$ 233,863	$1,119,642	$1,588,395	$ 6,802	$1,595,197	100.0	
Net Usable Inventory										$5,488,777

*/ Meaning inventory exclusive of that referred to in the last paragraph of Joint Exhibit 7-G.

** Additional reserve required to reduce the inventory of Fast-back drills to estimated net realizable value.

Prepared: June 20, 1972

THOR POWER TOOL COMPANY

SUMMARY OF INVENTORIES
AND
VALUATION RESERVES
AS OF OCTOBER 31, 1971

	Gross Usable Inventory */	Inventory Supply– Based on Prior Year's Usage: 1-12 Mos.	13-18 Mos.	19-24 Mos.	Over 24 Mos.	Valuation Reserves: Based on Formula	Special**	Total	% of Reserve	Net Usable Inventory
Thor Power Tool Division										
Raw Material	$ 409,447	$ 358,635	$ -	$ -	$ 50,812	$ 50,812	$ (226)	$ 50,586	3.3	$ 358,861
Completed Parts and Accessories	3,448,395	2,075,237	293,353	180,204	899,601	1,181,430	25,577	1,207,007	78.7	2,241,388
Work-in-Process	822,593	752,933	-	-	69,660	69,660	(913)	68,747	4.5	753,846
Finished Goods, other than Parts and Accessories	1,250,013	943,335	43,065	28,488	235,125	278,024	(121,811)	156,213	10.1	1,093,800
Total	5,930,448	4,130,140	336,418	208,692	1,255,198	1,579,926	(97,373)	1,482,553	96.6	4,447,895
Cincinnati Rubber Division										
Raw Material	128,161	127,456	-	-	705	705	-	705	0.1	127,456
Work-in-Process	118,993	118,993	-	-	-	-	-	-	-	118,993
Finished Goods	124,398	73,373	-	-	51,025	51,025	-	51,025	3.3	73,373
Total	371,552	319,822	-	-	51,730	51,730	-	51,730	3.4	319,822
Total Usable Inventory */	$6,302,000	4,449,962	336,418	208,692	1,306,928					
Valuation Reserves										
Formula		-	50%	75%	100%					
Amount		$ -	$ 168,209	$ 156,519	$1,306,928	$1,631,656	$ (97,373)	$1,534,283	100.0	
Net Usable Inventory										$4,767,717

*/ Meaning inventory exclusive of that referred to in the last paragraph of Joint Exhibit 7-G.

** Adjustment to the reserve, calculated on a formula basis, required to yield estimated realizable value for the inventory of completed Fast-back drills, hedge trimmers and bench grinders plus their associated parts and materials.

Prepared: June 20, 1972

Petitioner's Exhibit 17

THOR POWER TOOL CO.
ANALYSIS OF
DISPOSITIONS AT
AURORA & LOS ANGELES

Year	Aurora	Los Angeles	Combined
1965	$ 46,769	$ 55,820	$102,589
1966	96,799	39,244	136,043
1967*	848	-0-	848
1968	180,617	11,366	191,983
1969	55,907	64,050	119,957
1970	97,020	15**	97,035
1971	9,467	-0-	9,467
	$487,427	$170,496	$657,922

* Petitioner's factory employees were on strike for approximately 7 months during 1967.

** The Los Angeles Plant was closed in 1970 and its inventory shipped to Aurora.

SUMMARY

1.	December 31, 1964 Inventory Reserve	$1,079,069
2.	Amounts attributable to L.A., Aurora & Branches	846,960
3.	Dispositions at L.A. and Aurora to 12/31/71	657,922

Taking into account only Los Angeles and Aurora, dispositions (line 3) account for nearly 78% of the related reserve provision (line 2) at Los Angeles, Aurora and the Branches.

Petitioner's Exhibit 19

THOR POWER TOOL COMPANY

SUMMARY OF TESTS OF RESERVE

FOR EXCESS INVENTORY BY

ARTHUR ANDERSEN & CO.

	Per AA&Co. Audit Work Papers for Year Ended December 31	
	1970	1971
Number of items tested	150 1/	58 2/
Total reserve for items tested	$ 208,246	$ 214,652
Total Reserve	$1,329,415	$1,550,186
% of total reserve tested	15.7%	13.8%
Net over- (under-) statement of reserve per AA&Co. test	$ (36,711)	$ (9,264)
% reserve understated per AA&Co. test	17.6%	4.3%
Number of items understated	128	44
% of items tested understated	83.3%	75.9%

1/ Items selected for test on the following basis:

(a) 20 largest items in value,
(b) 8 blocks of 10 items, and
(c) 50 items at random.

2/ Items selected for test on the following basis:

(a) All items (18) over $5,000 in "Over 24 Month" column of inventory evaluation list, and

(b) 4 blocks of 10 items.

THOR POWER TOOL COMPANY

SUMMARY OF INCOME STATEMENT
DOMESTIC CONSOLIDATION

Year Ended December 31
(000 omitted)

	1962	1963*	1964*	1965	1966	1967	1968	1969	1970	1971
Net Sales	$30,856	$29,727	$28,422	$25,439	$23,729	$18,752	$17,838	$16,741	$15,093	$13,263
Cost of goods sold	19,878	19,085	22,374	17,945	17,410	14,637	14,436	13,985	12,914	10,871
Gross income	$10,978	$10,642	$ 6,048	$ 7,494	$ 6,319	$ 4,115	$ 3,402	$ 2,756	$ 2,179	$ 2,392
% of net sales	35.6%	35.8%	21.3%	29.5%	26.6%	21.9%	19.1%	16.5%	14.4%	18.0%
Other expenses, net	8,705	9,088	9,084	6,974	6,548	5,945	4,485	4,709	4,702	4,045
% of net sales	28.2%	30.6%	32.0%	27.4%	27.6%	31.7%	25.1%	28.1%	31.2%	30.5%
Dividends from foreign subsidiaries	(265)	(280)	(210)	(202)	(779)	(280)	--	--	--	(2,494)
Income (loss) before income taxes	$ 2,538	$ 1,834	$(2,826)	$ 722	$ 550	$(1,550)	$(1,083)	$(1,953)	$(2,523)	$ 841
% of net sales	8.2%	6.2%	(10.0%)	2.8%	2.3%	(8.3%)	(6.1%)	(11.7%)	(16.7%)	6.3%
Provision (credit) for income taxes	1,165	762	(1,298)	263	39	(67)	--	--	--	--
Net income (loss)	$ 1,373	$ 1,072	$(1,528)	$ 459	$ 511	$(1,483)	$(1,083)	$(1,953)	$(2,523)	$ 841
Net increase (decrease) in reserve for excess inventory		$152**/	$ 927	$ 309	$ (104)	$ 679	$ 41	$ (619)	$ 210	$ (61)

* Prior to restatement

** Balance as of December 31 1963

Petitioner's Exhibit 22

THOR POWER TOOL COMPANY

RESERVE FOR EXCESS AND OBSOLETE INVENTORIES
DOMESTIC CONSOLIDATION

(000 Omitted)

Year Ended Dec.31	Balance at Beginning of Year	Provision Charged (Credited) to Operations			Dispositions(1)	Balance at End of Year
		Excess Inventory	Obsolete Inventory	Total		
1964	$ 152	$ 927	$2,684	$ 3,611	$ --	$3,611
1965	3,763	309	581	890	(1,270)	3,383
1966	3,383	(104)	367	263	(452)	3,194
1967	3,194	679	(418)	261	(122)	3,333
1968	3,333	41	118	159	(896)	2,596
1969	2,596	(619)	427	(192)	(438)	1,966
1970	1,966	210	536	746	(594)	2,118
1971	2,118	(61)	365	304	(241)	2,181

(1) Dispositions of excess, obsolete, and damaged inventories, net of proceeds received.

THOR POWER TOOL COMPANY

Analysis of Bad Debt Reserve
Requirement as of
December 31, 1965

Account	Total Receivable	Basis For Reserve	Amount of Reserve	Considered Collectible
Intercompany Accounts	$1,637,263	None	-0-	$1,637,263
Cincinnati Rubber Division	198,149	2 accounts 100% remainder 1%	4,550	193,599
Power Tools Div.				
Current Accounts (0-29 days past due)	1,744,815	1%	17,448	1,727,367
30-59 days past due	589,374	2%	11,787	577,587
60-90 days past due	249,995	2%	5,000	244,995
Over 90 days past due: (a) Balances over $100:				
(i) "Hard Core"	161,898*/	100%	161,898	-0-
(ii) Other	358,043	2%	7,160	350,883
(b) Balances under $100:				
(i) "Hard Core"	19,493**/	100%	19,493	-0-
(ii) Other	43,231	2%	865	42,366
Pending Claims For Credits	222,455	---	---	---
Payments Received to 2/31/65	(296,751)	---	---	---
isc. Adj.	---	---	746	---
OTALS	$4,927,965	---	$226,947	$4,699,018

/ Determined by management review of each account in light of currently available credit information and past experience with each debtor. Amount reserved against shown after deduction of pending claims for credit against these accounts.

*/Applied same ratio of "Hard Core" to "Other" as was determined by individual review for accounts over $100.

EXHIBIT 29

DIVISION OF FEDERAL TAXATION
of the
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Comments on the Proposed Regulations
Under Section 471 and Other Related Sections of the
Internal Revenue Code of 1954
Regarding Valuation of Inventories

April 17, 1972

GENERAL COMMENTS

We have mixed reactions about the proposed regulations. On the one hand, we commend the Internal Revenue Service for its effort to develop more definitive rules for the pricing of inventories of manufacturers for tax purposes. On the other hand, we strongly oppose the imposition of "financial statement eligibility tests" and urge that such tests not be made part of any final regulations in this area. Our concern also extends to the definitions and procedures prescribed for cost determination, the proposed transitional rules, the importance of consistency in inventory valuation and valuation matters not presently covered by the proposed regulations.

Opposition to financial statement eligibility tests. The American Insitute of CPAs believes that greater conformity of tax and financial accounting is a desirable goal, but this goal should be achieved without "financial statement eligibility tests." Such tests, which either in fact or in effect provide that an accounting method may be adopted or used for tax purposes only if the same method of accounting is used for financial reporting purposes, may inhibit the development of accounting principles.

It should also be noted that in attempting to achieve the objective of conforming tax and financial accounting, it is in-

consistent for tax accounting rules to be spelled out in such great detail as is the case in these proposed regulations. This detail, in effect, promulgates new accounting principles rather than adopts generally accepted accounting principles, where applicable, for federal income tax purposes.

* * *

Certain valuation matters not covered. An important valuation matter not covered relates to the problem of determining appropriate costs for inventory quantities in excess of prospective demand. This is especially troublesome when such items as repair parts carried to service obsolete models are greater than indicated customer needs. While quantities in excess of anticipated needs could be scrapped and thereby eliminated from inventory values, the cost of producing additional parts, in the event that actual future need is greater than presently estimated, would be prohibitive.

Management of companies, as well as their independent accountants engaged to attest to their financial statements, faced with this problem, are acutely aware of the high order of risk associated with carrying inventories of excess stocks at full cost values. Failure to recover such cost values on inventories carried in anticipation of future sales that do not in fact materialize is one of the most common causes of business failure. Under such circumstances, management is usually reluctant to represent that such excess stocks are worth full value, and their independent accountants are unwilling to accept full cost value in expressing their professional opinion on the financial statements involved. Many companies having such problems have developed methods of inventory valuation for slow-moving or excess stocks which attribute only fractions of the original costs thereto. These practices are generally regarded as appropriate and necessary to take into account the reduced economic values resulting from limited demand. Such inventory write-downs are analogous to adjustments to "market" under the "lower of cost or market" inventory valuation method. Usually, a system of discounting

is developed on a judgmental basis, consistently applied. The result is generally satisfactory for management in carrying out its stewardship and reporting responsibilities, and it is usually acceptable to the company's independent accountants.

Steps should be taken to modify the regulations regarding the valuation of slow-moving or excess stocks in order to recognize the fundamental soundness of applying reductions to those portions of inventories where current information clearly indicates that realization of full cost through ultimate sale is unlikely.

* * *

JOINT EXHIBIT 7-G

Page 5

THOR POWER TOOL COMPANY

U. S. Corporate Income Tax Return
1964

Schedule A—Question 2

The inventories at December 31, 1964 were priced at the lower of cost <first-in, first-out> or market, such inventories are stated on the same basis and were determined generally in the same manner as inventories at December 31, 1963 except that as a result of revision in operating policies made late in 1964, revised procedures were adopted to value excess stock. The valuation of inventories of excess stock at December 31, 1964 was determined generally by reference to usage in the past year and the application of the following percentage write-downs:

50% of that portion of the quantity of an item in excess of 12 months supply.

An additional 25% applied to that portion of the quantity of an item in excess of 18 months supply.

A further write down of 25% applied to that portion of the quantity of an item in excess of 24 months supply.

It is believed that, as a result of the above procedures, the inventory is stated at the lower of cost or market. The resulting percentage write-down totaled $1,079,069.

Old items for which there was no usage in the past year have been obsoleted and charged off.

EXHIBIT P

[THOR POWER TOOL COMPANY]

[1964 ANNUAL REPORT]

[President's Letter to Shareholders]

TO THE SHAREHOLDERS OF
THOR POWER TOOL COMPANY:

* * *

The Company and its subsidiaries incurred a consolidated operating loss of $2,239,454 for the year ended December 31, 1964. After adjustment for the resulting tax effect, the net loss for the year was $1,388,058.

These results are before taking into account an extraordinary charge in the amount of $3,608,052, after giving effect to income tax adjustments. Such extraordinary charge relates principally to excess, obsolete and damaged inventories, and to the provision of additional reserves, more specifically referred to later, against costs and liabilities, and against the values of certain of the Company's other assets.

A portion of the 1964 loss and, to a greater degree, of the extraordinary charge, resulted from changes in accounting practices and principles. (See Note (1) to the financial statements.) Certain of the charges made at the year-end result from the exercise of present management's judgment and discretion and are not susceptible of precise mathematical computation. Your new management believes, and your board of directors concurs, that it was prudent to adopt the more conservative accounting policies and practices which were employed in evaluating the assets and liabilities of the Company at December 31, 1964.

The charges recorded in the Company's books at December 31, 1964 relate to operations up to that time, and it is not expected that they, in and of themselves, will have a favorable effect on Thor's operations from that date forward except that

such future operations will not have to bear the costs of those liabilities against which reserves have now been provided, as they would have had to do under the Company's prior accounting practices.

Thor's loss for 1964 resulted, in large part, from excessive operating costs, including high production costs which, in many instances, were not being accurately measured. An urgent program is being initiated toward the establishment of more effective cost accounting systems. This cannot be accomplished quickly and it will be some time, therefore, before the benefits to be derived from such changes in cost accounting procedures can be realized.

* * *

Net Income

As stated earlier in this report, Thor's 1964 operations resulted in a consolidated net loss (after tax credits) of $1,388,058, before the deduction of an extraordinary charge totaling $3,608,052 (after income tax adjustments).

The extraordinary charge includes a provision for losses from excess, obsolete and damaged inventories, and to reflect in the accounts, at the year end, appropriate reserves for anticipated product warranty and return goods expenses, losses on receivables, the write-off of special tooling and engineering costs which previously had been deferred, compensation of retirees, other liabilities and similar items.

* * *

Arthur R. Collins
President

Aurora, Illinois
April 9, 1965

THOR POWER TOOL COMPANY AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

December 31, 1964 and 1963

ASSETS

	1964	1963
CURRENT ASSETS:		
Cash	$ 1,343,244	$ 863,506
Receivables, less allowance for doubtful accounts ($230,130 for 1964 and $100,792 for 1963)	5,807,597	6,510,348
Refundable United States income taxes	1,885,800	—
Inventories, priced at lower of standard cost (first-in, first-out) or market:		
Finished products and work in process	7,929,296	12,149,213
Raw materials and supplies	1,293,113	2,124,852
	9,222,409	14,274,065
Prepaid expenses	189,327	254,520
Total current assets	18,448,377	21,902,439
OTHER ASSETS:		
Deferred charges	754,456	625,519
PROPERTY, PLANT AND EQUIPMENT, AT COST:		
Land	375,136	452,036
Buildings	3,832,655	3,568,224
Machinery and equipment	9,378,060	9,357,825
	13,585,851	13,378,085
Less accumulated depreciation	7,994,631	7,540,171
	5,591,220	5,837,914
	$24,794,053	$28,365,872

LIABILITIES

	1964	1963
CURRENT LIABILITIES:		
Bank loans	$ 3,327,170	$ 2,093,517
Current portion of long-term debt	300,000	300,000
Accounts payable	2,507,081	2,301,256
Accrued wages, withholding and other taxes	1,154,091	1,096,044
Other accrued liabilities	1,173,031	248,371
United States and foreign taxes on income (less foreign tax certificates, $247,800 in 1964 and 1963)	404,880	1,177,643
Total current liabilities	8,866,253	7,216,831
OTHER LIABILI[illegible]		
Pensions and deferred payments, net of income taxes	1,311,326	659,705
LONG-TERM DEBT (Note 3):		
4⅞% convertible subordinated debentures due June 1, 1981	4,000,000	4,000,000
4% sinking fund notes payable, $150,000 due annually with final payment in 1971	1,250,000	1,400,000
5¼% sinking fund notes payable, $150,000 due annually with final payment in 1973	1,550,000	1,700,000
	6,800,000	7,100,000
STOCKHOLDERS' EQUITY:		
Capital stock, without par value: (Notes 7 and 8)		
Authorized 2,000,000 shares		
Issued 826,803 shares (before deducting shares held in treasury)	5,326,300	5,326,300
Retained earnings (Note 3)	5,454,473	11,032,585
	10,780,773	16,358,885
Less shares held in treasury, at cost (99,200 shares in 1964 and 99,400 shares in 1963)	2,964,299	2,969,549
	7,816,474	13,389,336
	$24,794,053	$28,365,872

See accompanying notes to financial statements.

STATEMENT OF CONSOLIDATED INCOME

Years Ended December 31, 1964 and 1963

	1964	1963
Net sales	$32,837,908	$33,714,349
Cost of sales	24,802,385	21,665,868
Gross income from sales	8,035,523	12,048,481
Selling and administrative expenses:		
Selling, service and advertising	6,610,818	6,290,391
General and administrative	3,069,399	2,695,819
	9,680,217	8,986,210
Operating income (loss)	(1,644,694)	3,062,271
Other charges:		
Interest	502,564	461,676
Miscellaneous	221,568	29,980
	724,132	491,656
Other income	129,372	87,862
Income (loss) before income taxes	(2,239,454)	2,658,477
Provision for income taxes (credit)	(851,396)	1,313,094
Net income (loss) for the year	(1,388,058)	1,345,383
Extraordinary charge, less tax effect of $2,734,090 (Note 1)	3,608,052	—
Net income (loss) for the year and extraordinary charge in 1964	($4,996,110)	$ 1,345,383

See accompanying notes to financial statements

* * *

NOTES TO FINANCIAL STATEMENTS DECEMBER 31, 1964

(1) The accounts of the company at December 31, 1964 reflect certain changes from the accounting practices and principles previously followed. Changes were made in the methods of determining and valuing obsolete and excess inventory. Tooling, and research and development costs, previously amortized over several years, are now being charged to expense as incurred. The accounting for payments under informal pension arrangements was changed from a "pay-as-you-go" method to a modified accrual method, and the company has elected to provide for the cost of past service with respect to the retirement plan for salaried employees over a 30 year period from 1958, the first full year of the plan. The company also has revised its estimates as to the total future payments to be made under deferred compensation arrangements. Reserves have been established for certain estimated expenses, claims and contingencies.

The major effect of the foregoing changes has been shown as an extraordinary charge in the statement of consolidated income for the year ended December 31, 1964.

* * *

ACCOUNTANTS' REPORT*

The Board of Directors
THOR POWER TOOL COMPANY:

We have examined the consolidated balance sheet of Thor Power Tool Company and subsidiaries as of December 31, 1964 and the related statements of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In view of the unsatisfactory operating results for 1964, the contemplated revisions in operating policies, and for other reasons, the present management of the company has made certain changes in the accounting principles and practices heretofore followed. The nature of these changes is indicated in Note 1 to the financial statements and the major effect of the changes has been reflected as an extraordinary charge in the statement of consolidated income. In part, the amounts allocated to the extraordinary charge are of necessity based on management's estimates and assumptions. While we believe the new procedures to be reasonable in the circumstances, their appropriateness, particularly as they relate to inventory valuation, can only be adequately evaluated in the light of future events.

In our opinion, subject to the comments in the preceding paragraph, the accompanying financial statements present fairly the financial position of Thor Power Tool Company and subsidiaries at December 31, 1964 and the results of their operations

*** This Opinion is received into evidence to show that the Exhibit contains a statement of the auditors but ". . . it does not prove the truth or the correctness of the matters contained in the statement of the auditor" (A43).**

for the year then ended, in conformity with generally accepted accounting principles which, except as stated above, have been applied on a basis consistent with that of the preceding year.

PEAT, MARWICK, MITCHELL & CO.

Chicago, Illinois
April 5, 1965

EXHIBIT Q

[THOR POWER TOOL COMPANY]

[1965 ANNUAL REPORT]

[President's Letter to Shareholders]

TO THE SHAREHOLDERS OF
THOR POWER TOOL COMPANY:

* * *

During 1965, the Company terminated its relationship with its former auditors and retained Price Waterhouse & Co., as its independent public accountants.

As stated in our letter to shareholders dated February 25, 1966, the Company recently completed a further investigation in order to attempt to allocate, to specific periods, the 1964 year-end adjustments aggregating $4,727,910 ($8,459,588 before applicable income tax credits), and to determine the extent to which the previously issued financial statements of the Company should be revised. As a result of this study, the Company filed with the Securities and Exchange Commission, on February 24, 1966, revised financial statements for the years ended December 31, 1964 and December 31, 1963 and for the six months period ended June 30, 1964. The operating results and other financial information for the year 1964 as stated in this annual report reflect the changes resulting from the allocation of the 1964 year-end adjustments to specific periods and conform with the revised statements filed with the Securities and Exchange Commission.

* * *

Net Income

For the year ended December 31, 1965, the Company and its subsidiaries earned a net profit of $293,012 after taxes, equal to $.40 per share of capital stock outstanding at the year-end. This compares with a net loss in 1964 of $1,038,691 ($1,454,955

before applicable income tax credits), prior to the deduction of a special charge of $1,490,051 ($2,632,051 before applicable income tax credits). The 1964 special charge consisted primarily of write-downs for obsolete and excess inventories which could not be allocated to specific periods because adequate information is not now available.

The reallocation of $3,237,859 of the total 1964 year-end adjustments to specific periods, as the result of the study discussed earlier, reduced previously reported earnings for 1962 and prior years by $1,876,494, and earnings for 1963 from $1,345,383 to $754,409. The net loss for 1964 of $1,388,058, before a special charge of $3,608,052, as recorded in the annual report for that year, was reduced to $1,038,691, and the special charge was reduced to $1,490,051. All of these figures are after the applicable income tax effects.

Working Capital

* * *

In 1965, the Company obtained a refund of Federal income taxes in the amount of $2,311,512, resulting from the loss reported for the year 1964, including the special charge. The tax refund together with funds resulting from the Company's profit for the year, provisions for depreciation, and from reductions in inventories and receivables were used to retire the Company's short-term bank loans, to meet $300,000 of maturities on its long-term debt, to pay past due accounts, and to add to working capital—for which there are many urgent needs.

* * *

Litigation

In our report for the first six months of 1965, we informed you that, following an investigation by independent legal counsel of the conduct of the Company's business by the previous management, the Company had filed suit for damages against three former officers and the estate of the deceased former chairman and president. This suit is pending. Its ultimate effect upon the Company's financial condition is uncertain because the financial resources of the defendants are unknown.

During 1965, two lawsuits were filed against the Company and several other defendants asserting claims based upon the conduct of the business by the previous management. Legal counsel for the Company have informed us that it is not possible to forecast the outcome of this litigation or its ultimate effect on the Company's financial condition because it involves many unsettled legal issues and uncertainties about the facts. However, the Company has been advised by its legal counsel that the Company's cross-claim against its former independent public accountants, who also are defendants in these lawsuits, has substantial merit, and that if the Company should be held liable in these lawsuits, it should prevail in its cross-claim for the amount of its liability.

* * *

ARTHUR R. COLLINS
President

Aurora, Illinois
March 31, 1966

THOR POWER TOOL COMPANY AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

December 31, 1965 and 1964

ASSETS

	1965	1964
CURRENT ASSETS:		
Cash and marketable securities (at cost)	$ 3,196,858	$ 1,343,244
Receivables, less allowance for doubtful accounts ($285,390 in 1965 and $230,130 in 1964)	4,479,154	5,807,597
Refundable United States income taxes (Note 3)	—	2,457,312
Inventories, priced at lower of standard cost (first-in, first-out) or market (Note 2):		
Finished products and work in process	6,600,504	8,519,578
Raw materials and supplies	533,323	702,831
	7,133,827	9,222,409
Prepaid expenses	137,651	189,327
Total current assets	14,947,490	19,019,889
OTHER ASSETS:		
Deferred charges	125,065	182,944
PROPERTY, PLANT AND EQUIPMENT, AT COST:		
Land	372,569	375,136
Buildings	3,914,279	3,832,655
Machinery and equipment	9,478,882	9,378,060
	13,765,730	13,585,851
Less accumulated depreciation	8,360,695	7,994,631
	5,405,035	5,591,220
	$20,477,590	$24,794,053

LIABILITIES

	1965	1964
CURRENT LIABILITIES:		
Bank loans	$ —	$ 3,327,170
Current portion of long-term debt	300,000	300,000
Accounts payable	634,697	2,507,081
Accrued wages, withholding and other taxes	1,068,811	1,154,091
Other accrued liabilities	1,353,259	1,173,031
United States and foreign taxes on income (less foreign tax certificates, $56,000 in 1965 and $247,800 in 1964)	1,124,134	404,880
Total current liabilities	4,480,901	8,866,253
OTHER LIABILITIES:		
Pensions and deferred payments, net of income taxes	1,387,203	1,311,326
LONG-TERM DEBT (Note 5):		
4⅞% convertible subordinated debentures due June 1, 1981	4,000,000	4,000,000
4% sinking fund notes, payable $150,000 annually with final payment in 1971	1,100,000	1,250,000
5¼% sinking fund notes, payable $150,000 annually with final payment in 1973	1,400,000	1,550,000
	6,500,000	6,800,000
SHAREHOLDERS' EQUITY:		
Capital stock, without par value (Notes 5 and 8):		
Authorized 2,000,000 shares		
Issued 826,803 shares (before deducting shares held in treasury)	5,326,300	5,326,300
Retained earnings (Note 5)	5,747,485	5,454,473
	11,073,785	10,780,773
Less 99,200 shares held in treasury, at cost	2,964,299	2,964,299
	8,109,486	7,816,474
	$20,477,590	$24,794,053

The accompanying notes to the consolidated financial statements are an integral part of these statements.

NOTES TO FINANCIAL STATEMENTS
AT DECEMBER 31, 1965

(1) A thorough assessment of the affairs of the Company and a careful evaluation of its assets and liabilities at December 31, 1964 resulted in adjustments aggregating $4,727,910 ($8,459,588 before applicable income tax credits) being reported in the Company's consolidated statements of income and retained earnings as of December 31, 1964. These adjustments were recorded in the 1964 statement of consolidated income (as it appeared in Thor's 1964 Annual Report), $1,119,858 being charged to 1964 operations and $3,608,052 being recorded as a special charge after net loss for the year. The allocation of the adjustments, as between 1964 operations and the special charge, was based upon the information that was then available. No attempt was made at that time to allocate these adjustments to specific prior periods.

As explained more fully in a letter to shareholders, dated February 25, 1966, the Company made a further study in order to attempt to allocate the 1964 year-end adjustments to specific periods. The reallocation of the 1964 year-end adjustments, which remained unchanged in total, to certain specific prior periods resulted in a reduction in earnings for 1962 and prior years of $1,876,494. Also, the previously reported earnings for 1963 were reduced from $1,345,383 to $754,409, and the reported 1964 loss of $1,388,058, before the special charge, was reduced to $1,038,691. The allocation of a portion of the year-end adjustments to specific periods reduced the special charge from $3,608,052, as reported in the 1964 Annual Report, to $1,490,051, representing adjustments that could not be allocated to specific periods because of insufficient supporting data. The accompanying comparative financial statements for 1964

have been restated to reflect the reallocation of 1964 year-end adjustments to specific periods.

(2) A substantial portion of the 1964 year-end adjustments represented provisions for losses from excess, obsolete and damaged inventories. During 1965, a portion of the obsolete and damaged inventories was physically disposed of, and the reserve for excess and obsolete inventory at the year end, after an additional 1965 provision of $1,051,000, reflects anticipated future requirements based on the Company's present marketing plans. The inventories shown on the accompanying balance sheets are stated net of reserves of $3,903,725 and $4,382,588 at December 31, 1965 and 1964, respectively.

* * *

(9) During 1965, two lawsuits were filed against the Company and several other defendants asserting claims based upon the conduct of the business by the previous management. Legal counsel for the Company have informed us that it is not possible to forecast the outcome of this litigation or its ultimate effect on the Company's financial condition because it involves many unsettled legal issues and uncertainties about the facts. However, the Company has been advised by its legal counsel that the Company's cross-claim against its former independent public accountants, who also are defendants in these lawsuits, has substantial merit and that if the Company should be held liable in these lawsuits it should prevail in its cross-claim for the amount of its liability.

Following an investigation, early in 1965, by independent legal counsel of the conduct of the Company's business by the previous management, the Company filed suit for damages against three former officers and the estate of the deceased former chairman and president. The ultimate effect of this lawsuit upon the Company's financial condition is uncertain because the financial resources of the defendants are unknown.

OPINION OF INDEPENDENT ACCOUNTANTS*

To the Board of Directors of
THOR POWER TOOL COMPANY:

We have examined the consolidated balance sheet of Thor Power Tool Company as of December 31, 1965 and the related statements of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The financial statements at December 31, 1964 were examined by other independent accountants, whose opinion dated April 5, 1965 was subject to the appropriateness of certain changes made during 1964 in accounting principles and practices, particularly as they are related to inventory valuation, which, while considered by them to be reasonable in the circumstances, could only be evaluated in the light of future events.

As explained in Note 2, substantial provisions were made in 1964 and 1965 to reduce certain inventories, considered by management to represent obsolete, damaged and excess stocks, to their estimated realizable value. While the reserves provided reflect the best current judgment of the company's management, it is not possible to evaluate these reserves prior to the ultimate disposition of the inventories involved.

In our opinion, subject to the effect of the ultimate adjustments arising from the disposition of the inventories referred to above, and subject to the final outcome of the pending litigation described in Note 9, the accompanying consolidated financial

*** This Opinion is received into evidence to show that the Exhibit contains a statement of the auditors but ". . . it does not prove the truth or the correctness of the matters contained in the statement of the auditor" (A43).**

statements present fairly the financial position of Thor Power Tool Company and its subsidiaries at December 31, 1965, and the results of their operations for the year, in conformity with generally accepted accounting principles. These principles were applied on a basis consistent with that of the preceding year, the financial statements for which were restated by the Company as described in Note 1.

PRICE WATERHOUSE & CO.

Chicago, Illinois
March 25, 1966

EXHIBIT R

[THOR POWER TOOL COMPANY]

[S.E.C. FORM 10-K]

[For the Fiscal Year Ended 1964]

* * *

ACCOUNTANTS' REPORT*

The Board of Directors
Thor Power Tool Company

We have examined the consolidated financial statements and related schedules of Thor Power Tool Company and subsidiaries as listed in the accompanying index. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In view of the unsatisfactory operating results for 1964, the contemplated revisions in operating policies and for other reasons, the present management of the company has made certain changes in the accounting principles and practices heretofore followed. The nature of these changes is indicated in note 1 to the financial statements and the major effect of the changes has been reflected as an extraordinary charge in the statement of consolidated income. In part, the amounts allocated to the extraordinary charge are of necessity based on management's estimates and assumptions. While we believe the new procedures to be reasonable in the circumstances, their appropriateness, particularly as they relate to inventory valuation, can only be adequately evaluated in the light of future events.

*** This Opinion is received into evidence to show that the Exhibit contains a statement of the auditors but ". . . it does not prove the truth or the correctness of the matters contained in the statement of the auditor" (A43).**

In our opinion, subject to the comments in the preceding paragraph, such financial statements present fairly the financial position of Thor Power Tool Company and subsidiaries at December 31, 1964 and the results of their operations for the year then ended, in conformity with generally accepted accounting principles which, except as stated above, have been applied on a basis consistent with that of the preceding year; and the supporting schedules, in our opinion, present fairly the information required to be stated therein.

PEAT, MARWICK, MITCHELL & Co.

Chicago, Illinois

April 5, 1965

Notes to Financial Statements

December 31, 1964

1. Changes in Accounting Practices and Principles:

The Accounts of the company at December 31, 1964 reflect certain changes from the accounting practices and principles previously followed. Changes were made in the methods of determining and valuing obsolete and excess inventory. Tooling and research and development costs, previously amortized over several years, are now being charged to expense as incurred. The accounting for payments under informal pension arrangements was changed from a "pay-as-you-go" method to a modified accrual method and the company has elected to provide for the cost of past service with respect to the retirement plan for salaried employees over a 30-year period from 1958, the first full year of the plan. The company also has revised its estimates as to the total future payments to be made under deferred compensation arrangements. Reserves have been established for certain estimated expenses, claims and contingencies.

The major effect of the foregoing changes has been shown as an extraordinary charge in the statement of consolidated income.

* * *

3. Inventories:

The inventories, priced at the lower of standard cost (first-in, first-out) or market, used in the computation of cost of sales for 1964 and, in part, the extraordinary charge, were as follows:

December 31, 1964	$ 9,222,409
December 31, 1963	14,238,482

As of December 31, 1964 the company, under new management, revised its methods and procedures with respect to

the determination of obsolete and excess quantities of inventories. A portion of the resulting charge has been allocated to the extraordinary charge. See note 1.

* * *

EXHIBIT S

[THOR POWER TOOL COMPANY]

[S. E. C. FORM 8]

[Amending Form 10-K for the Year Ended December 31, 1964]

* * *

Exhibit A

THOR POWER TOOL COMPANY

Introductory Statement

Explanation of Revisions to Financial Statements
Filed in Form 8

As a result of the events relating to the rescission of a purchase and sale agreement dated August 20, 1964, with Stewart-Warner Corporation, Thor's present management conducted extensive investigations, and determined that adjustments aggregating $4,727,910 ($8,459,588 before applicable income tax credits) should be made to consolidated income and retained earnings as of December 31, 1964. These adjustments were recorded in the 1964 statement of consolidated income, $1,119,858 being charged to 1964 operations, and $3,608,052 being recorded as a special charge after net loss for the year. The allocation of the adjustments as between 1964 operations and the special charge was based upon information that management was able to obtain in the limited time available. No attempt was made at that time to allocate these adjustments to specific prior periods.

In order to amend certain reports previously filed with the Securities and Exchange Commission, a further study has been made in order to allocate these adjustments, which remain unchanged in total, to certain specific periods, wherever deter-

minable, as follows: (a) the year ended December 31, 1964, (b) the six months ended June 30, 1964, (c) the year ended December 31, 1963, and (d) 1962 and prior periods. No audit has been made of the data which were accumulated and used as a basis for the allocations to periods.

As a result of this study, the 1964 year-end adjustments have been divided into three classifications as follows:

1. Adjustments, other than those related to changes in the application of generally accepted accounting principles, which can be allocated to periods on the basis of information obtained by the current study ($3,956,000 before income tax credits and $2,201,000 after income tax credits).

In determining the allocations of the adjustments to periods, prior periods have not been charged with adjustments resulting from operating decisions made by the present management.

A significant portion of the adjustments which are shown as applicable to the six months ended June 30, 1964, represents a pro rata allocation on a monthly basis of certain adjustments determined as applicable to the year 1964.

See Note 1 of page 5 of this Exhibit for further details with respect to these adjustments.

2. Adjustments related to changes in the application of generally accepted accounting principles ($1,872,000 before income tax credits and $1,037,000 after income tax credits).

Certain of the adjustments reflected changes in the application of generally accepted accounting principles (which management in each case considered a more realistic practice in the circumstances). All of these changes have been retroactively allocated to periods as if the alternative accounting practices selected by the present management had been in effect during those periods.

See Note 2 on page 8 of this Exhibit for further details with respect to these adjustments.

3. Adjustments not allocated to periods ($2,632,000 before income tax credits and $1,490,000 after income tax credits).

These adjustments, which consist primarily of write-downs for obsolete and excess inventories, may relate to several periods. The limited information available does not provide an adequate basis for allocation to any specific period, and accordingly these adjustments have been classified as a special charge after net loss for 1964.

The tabulations which follow summarize the adjustments by the three classifications previously described, and set forth the effects of the allocations of the adjustments described in (1) and (2) above on net income and retained earnings reported in prior periods.

A summary of the adjustments by classifications as described above and of the results of the allocations is set forth below:

	Total Adjustment		Allocate Adjustments, Other Than Changes in the Application of Generally Accepted Accounting Principles		Changes in the Application of Generally Accepted Accounting Principles		Adjustments Not Allocated to Periods	
	Before Tax Credits	After Tax Credits	Before Tax Credits	After Tax Credits	Before Tax Credits	After Tax Credits	Before Tax Credits	After Tax Credits
				(In Thousands)				
Allocated to year ended December 31—								
1964	$1,344	$ 770	$1,119	$ 628	$ 225	$ 142	$ —	$ —
1963	1,039	591	820	471	219	120	—	—
1962 and prior	3,445	1,877	2,017	1,102	1,428	775	—	—
Not allocated	2,632	1,490	—	—	—	—	2,632	1,490
	$8,460	$4,728	$3,956	$2,201	$1,872	$1,037	$2,632	$1,490
Allocated to six months ended June 30, 1964	$1,459	$ 762	$1,277	$ 661	$ 182	$ 101	$ —	$ —

The effect on the net income and retained earnings reported in prior periods of the allocations discussed above is as follows:

	Total Adjustment	Year Ended December 31, 1964		Net Income for Year Ended Dec. 31, 1963	Retained Earnings at Dec. 31, 1962	Net Income (Loss) for Six Months Ended June 30, 1964 (Memo)
		Net (Loss) for the Year	Special Charge			
			(In Thousands)			
As reported	$(4,728)	$(1,388)	$(3,608)	$1,345	$10,850	$ 613
To reverse 1964 year-end adjustments as recorded	4,728	1,120	3,608	—	—	—
	$ —	$ (268)	$ —	$1,345	$10,850	$ 613
Adjustments allocated to specific periods (excluding adjustments for changes in the application of generally accepted accounting principles) (Note 1)	(2,201)	(628)	—	(471)	(1,102)	(661)
Restated for adjustments allocated to specific periods (before changes in the application of generally accepted accounting principles)	$(2,201)	$ (896)	$ —	$ 874	$ 9,748	$ (48)
Adjustments resulting from changes in the application of generally accepted accounting principles (Note 2)	(1,037)	(142)	—	(120)	(775)	(101)
Restated for all adjustments allocated to specific periods	$(3,238)	$(1,038)	$ —	$ 754	$ 8,973	$(149)
Adjustments not allocated to periods (Note 3)	(1,490)	—	(1,490)	—	—	—
As restated	$(4,728)	$(1,038)	$(1,490)	$ 754	$ 8,973	$(149)

Notes:

(1) Adjustments allocated to specific periods, excluding adjustments for changes in the application of generally accepted accounting principles, consisted principally of the following (amounts shown are before income tax credits):

	Total Adjustment Allocated to Periods
a. Provisions for losses on damaged inventories of \$422,000 and obsolete inventories of \$447,000. The damaged inventories consisted primarily of defective or damaged tools returned by customers and which could not be repaired economically. The provision for obsolete inventories relates to certain specific tools and parts which were no longer produced by the Company or listed in its current catalogs, or for which the record showed little or no usage for a period of time. (This does not include other provisions for losses on obsolete and excess stocks of inventories which are included in the unallocated adjustments—see Note (3) (below.)	\$ 869,000
b. Adjustments to write off inventories relating to three specific unsuccessful products.	308,000
c. Adjustments to write off (i) tools being used for demonstration purposes by salesmen and branches, and (ii) various tools on trial with customers.	347,000
d. Other adjustments to inventories, including correction of an overstatement (\$118,000) in the Italian subsidiary's December 31, 1963, inventory and elimination from inventory valuations of excessive costs (\$431,000) and intercompany profits (\$79,000).	628,000

	Total Adjustment Allocated to Periods
e. Provisions for returns and allowances and for doubtful accounts in order to state accounts receivable, net of reserves, at the amount of cash estimated to be realizable.	405,000
f. Write-off of the unamortized balance of production tooling costs applicable to discontinued, obsolete and other products where there were significant doubts that the costs could be recovered	364,000
g. Provisions for payments to be made under certain compensation contracts: (i) supplemental payments to retired and former employees under various arrangements (\$297,000), and (ii) payments under deferred compensation contracts with former officers (\$305,000). No provisions had previously been made in the accounts for the payments described in (i), and payments had been charged to expense as they were made; the adjustments at December 31, 1964, record the liability, actuarially computed, to these retired and former employees. The adjustments at December 31, 1964, with respect to the payments described in (ii) increase the reserve to the amount required at that date.	602,000
h. Other year-end adjustments, including provisions for (i) loss on purchase commitments (\$215,000) and (ii) legal expenses (\$125,000), and (iii) adjustments of miscellaneous accrued costs and liabilities (\$93,000).	433,000
i. 1964 adjustments other than year-end adjustments which affected the restatement of results of operations by periods.	—

	Total Adjustment Allocated to Periods
Total adjustments before income tax credits	$3,956,000
Less—Income tax credits	1,755,000
Total adjustments after income tax credits allocated to specific periods, excluding adjustments for changes in the application of generally accepted accounting principles	$2,201,000

The allocation of the adjustments listed above is summarized by periods in the tabulation below:

	Total Adjustment	Allocated to Year Ended December 31: 1964	1963	1962 and Prior	Allocated to Six Months Ended June 30, 1964 (Memo)
			(In Thousands)		
(a) Provisions for damaged and obsolete inventories	$ 869	$ 137	$ 271	$ 461	$ 69
(b) Write-off of inventories of three specific products	308	308	—	—	—
(c) Write-off of demonstrator tools and tools on trial....................	347	71	89	187	16
(d) Other adjustments to inventories.....	628	431	118	79	212
(e) Provisions for returns and allowances and doubtful accounts	405	(35)	104	336	159
(f) Write-off of certain production tooling costs	364	217	(6)	153	(4)
(g) Provisions for certain compensation contracts	602	57	(34)	579	3
(h) Other year-end adjustments.........	433	293	82	58	4
(i) Allocation to prior periods of 1964 adjustments recorded before year-end—					
Physical inventory adjustments disclosed at September 30, 1964...	—	(257)	125	132	500
Correction of certain errors in the recording of sales, inventories and other items primarily as of June 30, 1964	—	(103)	71	32	318
	$3,956	$1,119	$ 820	$2,017	$1,277
Less—Income tax credits	1,755	491	349	915	616
Total	$2,201	$ 628	$ 471	$1,102	$ 661

(2) Adjustments resulting from changes in the application of generally accepted accounting principles included changes in accounting for (a) factory and office supplies, (b) tooling, (c) research and engineering costs, (d) pension costs, (e) employees' vacation pay, (f) investment tax credit, and (g) goodwill, as follows:

a. Factory and office supplies, previously capitalized and charged to income when used, are now charged to expense when purchased.

b. The Company previously followed the policy of capitalizing tooling costs and amortizing these costs over periods ranging from five to ten years. The previously unamortized balance of tooling costs in the accounts at December 31, 1964, is now being written off over a single five-year period 1964-1968. Under the new policy effective January 1, 1965, expenditures for tooling made after 1964 are charged to expense as incurred.

c. The Company previously followed the policy of deferring certain research and engineering costs and amortizing these costs over a four-year period. Under the new policy, these costs are charged to expense as incurred.

d. The Company previously provided each year for the annual normal cost and interest on unfunded past-service costs of the salaried employees' retirement plan; however, no provisions had been made for amortization of the past-service costs. Under the new policy, the Company continues to charge income for the annual normal cost and interest on the unfunded past-service cost; in addition, it is amortizing the unfunded past-service cost over a thirty-year period starting in 1958, the first full year of the retirement plan.

e. The Company previously followed the policy of charging expense for the cost of vacations by salaried and certain hourly employees when the vacations were taken. Under the new policy, the Company accrues on a pro rata basis for the cost of these vacations during the year in which these vacations are earned.

f. During 1962 and 1963 the Company reflected 48% of the investment tax credit in income as a reduction of income tax expense for the year in which the credit arose and deferred the balance as part of the liability for Federal income taxes. During 1964, the Company's accounting policy was changed to amortize the investment credit over the useful lives of the applicable equipment.

g. Under the Company's previous policy, goodwill was being amortized by annual provisions which would have run through 1976, or a period of about twenty years from the date of acquisition of the assets and business of a predecessor company. The Company decided in 1964 to write off the unamortized portion of the goodwill. In effect, this results in a change from the twenty-year amortization period previously used, to a ten-year period.

The effect of the retroactive change in the application of generally accepted accounting principles is summarized as follows:

	Total Adjustment	Allocated to Year Ended December 31 1964	1963	1962 and Prior	Allocated to Six Months Ended June 30, 1964 (Memo)
		(In Thousands)			
Factory and office supplies	$ 91	$(18)	$ 24	$ 85	$ (8)
Tooling	166	166	—	$ —	83
Research and engineering costs	798	—	117	681	—
Pension costs	484	52	72	360	26
Vacation pay	206	(13)	(11)	230	82
Investment credit	57	30	9	18	(5)
Goodwill	70	8	8	54	4
	$1,872	$225	$219	$1,428	$182
Less—Income tax credits	835	83	99	653	81
Total	$1,037	$142	$120	$ 775	$101

(3) Adjustments not allocated to periods consist primarily of write-downs for obsolete and excess inventories and have been reflected in the accompanying financial statements as a special charge in 1964 because inadequate information is available to support allocation to periods.

* * *

Exhibit E

Notes to Statements of Consolidated Income
and Consolidated Retained Earnings
Years Ended December 31, 1964 and 1963

(1) 1964 Year-End Adjustments and Their Allocation to Accounting Periods:

As a result of the events relating to the rescission of the purchase and sale agreement with Stewart-Warner Corporation, Thor's management conducted extensive investigations and determined that adjustments aggregating $4,727,910 ($8,459,588 before applicable income tax credits) should be made to consolidated income and consolidated retained earnings as of December 31, 1964. The nature of these adjustments, the allocation thereof to periods as a result of a subsequent study and the resulting restatements of consolidated income and retained earnings for the years ended December 31, 1964 and 1963, are summarized in Exhibit A.

* * *

(3) Inventories:

The inventories, priced at the lower of standard cost (first in, first out) or market, used in the computation of cost of sales for 1964 and 1963 were as follows:

December 31, 1964	$ 9,222,000
December 31, 1963	12,704,000
December 31, 1962	11,623,000

* * *

EXHIBIT T

[THOR POWER TOOL COMPANY]

[S. E. C. FORM 10-K]

[For the Fiscal Year Ended December 31, 1965]

* * *

March 25, 1966

OPINION OF INDEPENDENT ACCOUNTANTS*

To the Board of Directors of
Thor Power Tool Company

We have examined the consolidated financial statements of Thor Power Tool Company listed in the accompanying index. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The financial statements at December 31, 1964 were examined by other independent accountants, whose opinion dated April 5, 1965 was subject to the appropriateness of certain changes made during 1964 in accounting principles and practices, particularly as they are related to inventory valuation, which, while considered by them to be reasonable in the circumstances, could only be evaluated in the light of future events.

As explained in Note 2, substantial provisions were made in 1964 and 1965 to reduce certain inventories, considered by management to represent obsolete, damaged and excess stocks, to their estimated realizable value. While the reserves provided reflect the best current judgment of the Company's management, it is not possible to evaluate these reserves prior to the ultimate disposition of the inventories involved.

*** This Opinion is received into evidence to show that the Exhibit contains a statement of the auditors but ". . . it does not prove the truth or the correctness of the matters contained in the statement of the auditor" (A43).**

In our opinion, subject to the effect of the ultimate adjustments arising from the disposition of the inventories referred to above, and subject to the final outcome of the pending litigation described in Note 10, the accompanying consolidated financial statements present fairly the financial position of Thor Power Tool Company and its subsidiaries at December 31, 1965, and the results of their operations for the year, in conformity with generally accepted accounting principles. These principles were applied on a basis consistent with that of the preceding year, the financial statements for which were restated by the Company as described in Note 1.

PRICE WATERHOUSE & CO.

[Caption Omitted]

DECISION

Pursuant to the opinion of the Court filed May 6, 1975, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED and DECIDED: That there is a deficiency in income tax due from the petitioner for the taxable year 1963 in the amount of $494,055.99; and

That there is a deficiency in income tax due from the petitioner for the taxable year 1965 in the amount of $59,287.48.

/s/ WILLIAM A. GOFFE
Judge

Entered: Jan 12 1976

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision without prejudice to the right of either party to contest the correctness of the decision entered herein.

MEADE WHITAKER
Chief Counsel
Internal Revenue Service
By: /s/ CHARLES B. WOLFE, JR.
Charles B. Wolfe, Jr.
Acting Assistant
Regional Counsel
22nd Floor South
219 South Dearborn Street
Chicago, Illinois 60604
Tel. No. (312) 353-3870
Date: Jan 5 1976

/s/ JOHN E. ALLEN
John E. Allen
Counsel for Petitioner
231 South LaSalle Street
Chicago, Illinois 60604
Date: January 5, 1976

[Caption Omitted]

NOTICE OF APPEAL

[Filed April 9, 1976]

Notice is hereby given that Thor Power Tool Company hereby appeals to the United States Court of Appeals for the Seventh Circuit from the decision of this court entered in the above captioned proceeding on the 12th day of January, 1976.

/s/ MARK H. BERENS
Mark H. Berens

/s/ JOHN E. ALLEN
John E. Allen
Room 1955
231 South LaSalle Street
Chicago, Illinois 60604
(312) 782-0600

Of Counsel
MAYER, BROWN & PLATT

Date: April 8, 1976

SUPREME COURT OF THE UNITED STATES

No. 77-920

Thor Power Tool Company,
Petitioner,
vs.
Commissioner of Internal Revenue

ORDER ALLOWING CERTIORARI

FILED MARCH 6, 1978

The petition herein for a writ of certiorari to the United States Court of Appeals for the Seventh Circuit is granted.